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The slowdown in world activity that began in early 2018 and intensified in the second half of the year has become increasingly patent in 2019 to date. The global expansion has lost steam amid persistent trade tensions and the gradual growth of areas of uncertainty. Moreover, the uneven performance of economic activity across the main areas has tended to be confirmed. The loss of momentum of euro area gross domestic product (GDP) contrasts with the ongoing relatively high dynamism of the US economy. In China, uncertainty persists as to how sharply its activity is slowing. Meanwhile, world trade contracted in the final stretch of 2018 and the latest indicators point to continued weakness at the beginning of this year. Globally, inflation rates continued on a downward trend governed by the behaviour of the energy component, while core inflation has generally held steady despite the continued strength of job creation.

Against this background, the main international bodies have tended to trim their GDP growth projections. There are, however, some differences in the persistence of the downward revisions. In some cases, activity is assumed to lose momentum only in the short term. The narrative of the various projections is that the observed slowdown has occurred because temporary shocks (the main recent European example is the new car exhaust emissions legislation) have coincided with factors which have dented agents' confidence (such as protectionist tensions, vulnerabilities in some emerging economies – most notably China– or uncertainties over the final outcome of Brexit or the course of economic policy in Italy). The basic difference is that, while some institutions consider that the effects of this loss of confidence will peter out in the next few quarters, others believe they will be more persistent.

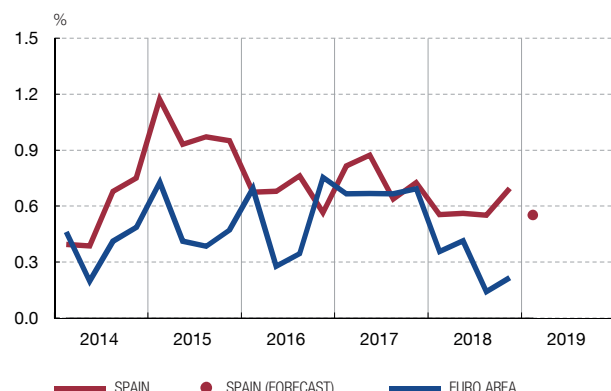
Economic policies have reacted to the worsening outlook for activity. Set against doubts over global growth, emerging financial market tensions and scant domestic inflationary pressure, the Federal Reserve adopted a more cautious stance at the beginning of the year. It thus declined to commit itself to the previously envisaged path of normalisation. Other central banks followed suit and financial markets were calmed. In the case of China, the authorities adopted a package of fiscal, monetary and financial stimulus measures.

In the euro area, economic activity remained weak at the beginning of 2019. The temporary domestic factors have had a longer-than-expected adverse effect. But the modest output growth is also explained by the severity with which the euro area has been hit by the world trade slump. This is because the euro area has a more open economy than other regions and because it specialises in exports to the geographical areas and products whose import flows have deteriorated most (see Box 2). Also, the impact on euro area exports seems to have begun to pass through to investment. These developments have seen a notable downward revision of the euro area's growth prospects, particularly for 2019. The ECB's latest projections are, however, for GDP to resume higher growth from the second half of the year as the temporary factors wind down and the uncertainties fade. The prevailing factors would then be the elements underpinning recovery, such as favourable financial conditions, the expansionary behaviour of employment and wages, lower oil prices and a slight fiscal easing. The expected inflation path has also been revised downwards.

Against this backdrop, on 7 March the European Central Bank (ECB) Governing Council decided on new measures to preserve the monetary stimulus. Specifically, it

In contrast to the deceleration in the euro area, activity continues to grow steadily in Spain. Inflation remains moderate, growing at rates somewhat below those of the euro area as a whole.

1 GROSS DOMESTIC PRODUCT (b)



2 HARMONISED INDICES OF CONSUMER PRICES



SOURCES: Eurostat, INE and Banco de España.

- a Quarter-on-quarter rates of change based on seasonally adjusted series in the case of GDP, and year-on-year rates of change based on the original series in the case of consumer price indices.
- b The figure for Q1 is a Banco de España projection.

extended the period during which it expects official rates to remain at their current levels and announced a new round of longer-term refinancing operations in order to maintain favourable credit conditions. As Box 4 illustrates, both the weaker macroeconomic scenario and the ECB's decisions are reflected in a postponement of the date on which financial markets expect the first rise in official interest rates.

The Spanish economy has maintained its notable dynamism. The available information indicates that in the first quarter GDP grew by around 0.6%, a similar rate to that throughout 2018. Spain was not immune to the external shock which, since the final stretch of the previous year, has manifested itself in a notable loss of export vigour. However, the dynamism of domestic demand offset the downturn in the external situation and activity has thus not slowed as in the euro area as a whole. In particular, private consumption has continued to exhibit notable strength, against a background of continuing swift job creation, an increase in purchasing power as a result of lower inflation (partly attributable to the oil price decline), a budgetary stimulus to household income (particularly in the second half of 2018) and a decrease in the rate of saving. By contrast, private investment has begun to feel the impact of the more unfavourable external situation. From the standpoint of the productive sectors, this development has also manifested itself in a worsening of manufacturing activity, while services have stood up better.

The current expansionary phase of the Spanish economy is expected to continue in the medium term. The baseline scenario underlying the updated macroeconomic projections of the Banco de España for the period 2019-2021 set out in Box 1 of this Report assumes that the global uncertainties will gradually peter out. The factors supporting activity include the assumption that the external markets will recover, the prevalence of benign financial conditions (favoured by the accommodative monetary policy stance) and, crucially, the progress made in restoring the macro-financial equilibrium of the economy (particularly the ongoing improvement of competitiveness, which is allowing a relatively high external balance to be maintained even in the current setting of worsening export

	2017	2018	2018				2019
			Q1	Q2	Q3	Q4	Q1
National Accounts							
Quarter-on-quarter rates of change, unless otherwise indicated							
Gross domestic product	3.0	2.5	0.6	0.6	0.6	0.7	0.6
Contribution of national demand (b)	2.9	2.9	0.8	0.7	0.8	0.4	0.6
Contribution of net external demand (b)	0.1	-0.4	-0.3	-0.1	-0.3	0.3	0.0
Year-on-year rates of change							
Employment	2.9	2.5	2.6	2.5	2.5	2.6	2.5
Price indicators (c)							
Harmonised index of consumer prices (HICP)	2.0	1.7	1.1	1.8	2.3	1.8	1.1
Harmonised index of consumer prices excl. energy and unprocessed food	1.2	1.0	1.1	1.0	0.9	1.1	0.9

SOURCES: INE and Banco de España.

a Information available up to 13 March 2019. The cells shaded in grey are Banco de España projections.

b Contribution to the quarter-on-quarter rate of change of GDP (pp).

c The 2019 Q1 figure is the average of the January and February year-on-year rates.

markets). In any event, the present projection is for GDP growth to gradually ease as monetary policy, while continuing to help sustain activity, exerts a lower impact on GDP growth than in the past. In particular, after growing by 2.2% in 2019, GDP will foreseeably grow by 1.9% and 1.7% in the following two years.

Turning to inflation, the consumer price index slowed significantly from end-2018. In February the year-on-year rate of change of the harmonised index of consumer prices (HICP) was 1.1%. Core inflation, measured by the rate of change of the index including only the prices of non-energy industrial goods and services, which in that month grew by 0.7%, continues to show no sign of rising. But in the projection period the growth rate of this indicator is expected to increase, reflecting a gradual rise in the positive output gap and higher unit labour costs, against a background of somewhat more expansionary wage behaviour.

The risks to projected activity are, in any event, tilted to the downside. In the external arena, the prospect of reaching agreement in the current US/China trade dispute has strengthened in recent months. Yet it cannot be ruled out that fresh protectionist tensions may emerge in other areas of the global economy. Moreover, risks persist that there will be a no-deal Brexit¹ and that China's more expansionary demand policies will prove insufficient to halt the deceleration of its economy. From a domestic perspective, the persisting uncertainty over future economic policies will only be vanquished when the executive and legislative powers appointed in the upcoming elections begin work under their mandate. The future economic policy agenda in Spain will have to focus on reducing the economy's vulnerability to shocks and fostering potential growth. It must therefore inescapably include the need to resume the process of budgetary consolidation and the adoption of measures to ensure that the main product and factor markets function more efficiently.

¹ J. L. Vega (coord), *Brexit: balance de situación y perspectivas*, Documentos Ocasionales nº 1905, Banco de España.

This box describes the key features of the most recent update of the Banco de España's economic projections for the Spanish economy. In comparison with the previous projections, published on 14 December 2018,¹ the current projections incorporate the preliminary results of the quarterly national accounts for the fourth quarter of 2018 and the changes in the technical assumptions derived from the information collected since the last exercise (see Table 1).²

The projections anticipate the prolongation of the upturn in the Spanish economy over the three-year period 2019-2021 (see Table 2). These expectations are based on the continued existence of the factors that have been underpinning growth since the start of the recovery including, in particular, the competitiveness improvements achieved since the start of the crisis, the strengthening of the financial situation of businesses, households and financial institutions and the accommodative stance of monetary policy. In addition, the prolongation, in the short run, of the expansionary budgetary policy stance should be mentioned. This combination of factors would allow the economy to continue

to grow at significantly above its potential rate, which would facilitate further absorption of the high unemployment generated by the crisis.

That said, the buoyancy of activity will tend to moderate over the projection horizon. In terms of annual average rates, after growing by 2.5% in 2018, growth is projected to be 2.2% in 2019, 1.9% in 2020 and 1.7% in 2021. As regards 2019, the slowdown basically reflects a deterioration in the external environment, which has been having a negative effect on exports since 2018 and which in the short run will contribute, through the impact on uncertainty, to a weakening in private demand (in particular, business investment).

In the medium and long run, various factors explain the projected moderation in the rate of growth. First, although monetary policy will continue to be expansionary, the effects on GDP growth of the measures implemented in this area in recent years will gradually decline. The convergence towards a more neutral monetary policy stance is now expected to be notably more gradual than was anticipated three months ago, as a result of the downward shift in the path of short-term interest rates expected by the markets. This is partly a consequence of the action taken by the ECB to guide agents' expectations and, in particular, of the decisions adopted by the Governing Council on 7 March.³

1 Macroeconomic projections for the Spanish economy (2018-2021): the Banco de España's contribution to the Eurosystem's December 2018 joint forecasting exercise.

2 The cut-off date for the December 2018 projections was 21 November 2018. The cut-off date for the present exercise is 7 March 2019, except for the data on export markets and the prices of competitors in their national currency, which were taken from the ECB staff macroeconomic projections for the euro area, March 2019, which had a cut-off date of 12 February 2019.

3 See Box 4 ("Market expectations about the euro area benchmark interest rate") and Section 3.2 of this Quarterly Report.

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

	2018	March 2019 projections			Difference between current projections and December 2018 projections (b)		
		2019	2020	2021	2019	2020	2021
International environment							
World output	3.5	3.3	3.4	3.3	-0.1	0.0	0.0
Spain's export markets	3.1	2.7	3.6	3.3	-0.6	-0.2	-0.1
Oil price in dollars/barrel (level)	71.1	64.9	64.4	62.8	-2.7	-2.4	-3.1
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.18	1.14	1.14	1.14	0.00	0.00	0.00
Nominal effective exchange rate vis-à-vis the non-euro area (c) (2000 = 100 and percentage differences)	121.5	117.7	117.6	117.6	-0.3	-0.3	-0.3
Short-term interest rate (3-month EURIBOR) (d)	-0.3	-0.3	-0.2	0.0	0.0	-0.2	-0.3
Long-term interest rate (10-year bond yield) (d)	1.4	1.3	1.5	1.8	-0.6	-0.6	-0.6

SOURCES: ECB and Banco de España.

a Assumptions cut-off date: 7 March 2019. The figures expressed as levels are annual averages; the figures expressed as rates are calculated based on the relevant annual averages.

b Differences are between rates in the case of world output and export markets, between levels in the case of oil prices and the dollar/euro exchange rate, percentages for the effective nominal exchange rate and in percentage points in the case of interest rates.

c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.

d For the projection period, the figures in the table are technical assumptions, prepared using the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

Also, although the expansionary fiscal measures approved since mid-2018 will support growth in the short run, in the absence of budget plans a neutral fiscal stance has been assumed for longer horizons. Finally, the projections incorporate the assumption that, given the current setting of continued relatively high levels of uncertainty and, above all, the historically low level of the savings ratio, households will be somewhat more cautious in their spending decisions. As a result, consumption dynamism is expected to moderate somewhat.

As for inflation, the extension of the upturn, with GDP growth rates above potential, is expected to lead to a gradual widening of the positive output gap and, therefore, to a rise in core inflation, as measured by the harmonised index of consumer prices (HICP),

excluding food and energy. Specifically, the annual average rate of change of this indicator is projected to be 1.1% in 2019, 1.6% in 2020 and 1.8% in 2021. The path of the overall HICP is not very different, given the expected behaviour of the energy component.

In comparison with the preceding projections, the most important change in the assumptions on which the forecasts are based, in terms of the impact on the final variables, is some deterioration in the outlook for Spain's export markets. This is reflected in a downward revision of 0.9 percentage points (pp), in cumulative terms, in the growth of these markets over the time horizon considered (see Table 1). Other changes, in the opposite direction, counteract the negative impact on activity arising from this revision. There has been a downward shift in the expected path of oil prices (measured in US

Table 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a)

Annual rate of change in volume terms and % of GDP

	2018	March 2019 projections			Difference between current projections and December 2018 projections		
		2019	2020	2021	2019	2020	2021
GDP	2.5	2.2	1.9	1.7	0.0	0.0	0.0
Private consumption	2.4	2.0	1.7	1.4	0.1	0.2	0.1
Public consumption	2.3	1.8	1.3	1.2	0.2	0.1	0.0
Gross fixed capital formation	5.2	3.9	3.8	2.7	-0.8	0.3	-0.1
Investment in capital goods, intangible and other (b)	4.9	3.2	3.3	2.1	-1.8	-0.2	-0.6
Investment in construction	5.5	4.6	4.3	3.2	0.1	0.7	0.4
Exports of goods and services	2.2	3.3	4.0	3.8	-0.1	0.0	0.0
Imports of goods and services	3.6	3.6	4.6	3.9	-0.4	0.5	0.2
National demand (contribution to growth)	2.9	2.3	2.0	1.7	-0.1	0.1	0.1
Net external demand (contribution to growth)	-0.4	-0.1	-0.1	0.0	0.1	-0.2	-0.1
Nominal GDP	3.5	3.6	3.5	3.5	-0.3	-0.2	-0.1
GDP deflator	0.9	1.4	1.6	1.8	-0.4	-0.1	-0.1
Harmonised index of consumer prices (HICP)	1.7	1.2	1.5	1.6	-0.4	-0.1	-0.1
HICP excluding energy and food	1.0	1.1	1.5	1.7	-0.4	-0.2	-0.1
Employment (full-time equivalent)	2.5	1.6	1.6	1.6	0.1	0.0	0.0
Unemployment rate (% of labour force). End-of-period data	14.4	14.0	12.8	12.1	-0.1	-0.1	-0.1
Unemployment rate (% of labour force). Annual average	15.3	14.2	13.2	12.3	-0.1	-0.1	-0.1
Nation's net lending (+) / net borrowing (-) (% of GDP)	1.2	1.1	0.8	0.7	0.3	0.1	0.1
General government's net lending (+) / net borrowing (-) (% of GDP)	-2.7	-2.5	-2.0	-1.8	-0.1	0.0	0.0

SOURCES: Banco de España and INE.
Latest QNA data: 2018 Q4

a Projections cut-off date: 13 March 2019.

b Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products.

dollars), which is beneficial to growth in the real incomes of private agents. At the same time, the expected paths of interbank market interest rates and public debt yields have moved downwards since the cut-off date for the assumptions of the preceding projections. Thus, although the cost of financing is expected to rise somewhat over the projection horizon, it is now not expected to rise by as much as three months ago.

Turning to budgetary policy, the changes in the assumptions are small. On 1 January 2019, the 2018 State budget was extended into 2019. This extension was accompanied by various royal decrees and remains in force following the rejection by Parliament on 13 February of the draft State budget for 2019 presented in January. These decrees included measures relating, in particular, to the updating of pensions, an increase in public sector wages, a rise in contribution bases (7%, in the case of the maximum base and in line with the increase in the national minimum wage, in the case of the minimum base) and changes in the arrangements for self-employed workers.⁴ However, only the latter two measures amount to changes with respect to the previous projections exercise, since the others had already been announced before the cut-off date for such projections and were incorporated in them. Also, more recently, the Government has approved further expansionary measures, including notably the extension of benefits to unemployed persons over the age of 52 and the extension of paternity leave to eight weeks.

Apart from the measures already adopted, it was decided, as in other recent projection exercises, to use technical assumptions to obtain the expected path of fiscal variables. The items of the general government accounts subject to most discretionality (including notably, due to their size, government consumption and public investment) are assumed to change in line with the nominal potential growth of the economy, while the path of other items is linked to the behaviour of their usual determinants. In particular, it is assumed that public revenues will grow in line with tax bases, which mainly depend on the macroeconomic environment. For less discretionary items of spending, including the measures recently approved by royal decree law, similar assumptions are proposed. As a result, it is assumed that pension spending changes in line with the increases approved for 2019 and, subsequently, will be determined by the legally established formula for increases and by population ageing. At the same time, unemployment benefit is linked to the behaviour of unemployment, and debt interest payments to the behaviour of public debt and

the cost of borrowing.⁵ In accordance with all these assumptions for the behaviour of budgetary variables and with the output gap estimated consistently with the other macroeconomic projections, fiscal policy will be expansionary in 2019. The budget deficit is projected to fall slightly in 2019, to 2.5% (0.2 pp less than in 2018), this being a slight upward revision (of 0.1 pp) with respect to the previous forecast, and subsequently somewhat more sharply, to reach 1.8% by the end of the forecast horizon.

The projected average annual GDP growth rates are unchanged from December. The main reason for this stability is that the overall impact on activity of the changes described in the assumptions that form the basis for the projections is more or less neutral. Moreover, as regards 2019, there are factors with the opposite sign that offset each other, so that the GDP growth projection remains at 2.2%. On the one hand, at the end of 2018 growth was somewhat more favourable than anticipated in previous projections. Also, the short-term information indicates that the economy remained buoyant in 2019 Q1, when GDP growth is estimated to have been 0.6%. On the other hand, activity is expected to be less buoyant in Q2 and Q3, in comparison with the December projections, as a consequence of the continued weakness of the euro area economy at the beginning of the year, as reflected in the recent ECB staff projections.⁶

For the two-year period 2020-2021, the lack of revisions to GDP growth is explained by the fact that, in line with these projections for the euro area, it is assumed that the factors that have caused euro area activity to weaken are predominantly temporary, and will therefore cease to operate from the end of this year, assuming that the main areas of risk arising from the global environment will not fully materialise.

As for inflation, the net effect of the new assumptions is, as in the case of activity, approximately neutral. However, the recent surprising behaviour of the core component, which suggests that the degree of pass-through to prices of the observed rise in the growth rate of unit labour costs has been lower than was expected in the December projections, justifies a downward revision to the path of core inflation. This revision should be more pronounced at the beginning than at the end of the projection period, as the ongoing decline in the degree of slack in the economy will cause inflationary pressures to rise.

Growth in activity will continue to be driven by national demand, although the latter's positive contribution to GDP growth will tend to moderate gradually over the forecast horizon. By contrast, the negative contribution of external demand to GDP growth, which was relatively large in 2018, will gradually decline, to reach zero in 2021.

Within national demand, the buoyancy of private consumption will continue to be supported by strong job creation. Also, the growth rate of household income will be driven by the projected rise in real wages and, in the short term, by the stimulus from the budgetary

4 Also incorporated in the projections for 2019 is the fact that a significant part of the impact of the changes in personal income tax approved in the budget for 2018 has, contrary to what was expected, still not been observed in the budget outturn data and has therefore been shifted to the current year.

5 An increase in public spending in 2018 was included in the December projections as a result of a Supreme Court judgment annulling the privatisation of Aigües del Ter i Llobregat, which took place in 2012. In practice, the increase in spending has been recorded in 2012, which resulted in a reduction in spending last year. Also, the income from the re-tendering of the insolvent toll motorways, which was previously expected in 2019 but is now expected later, has been excluded.

6 ECB staff macroeconomic projections for the euro area, March 2019.

measures approved in 2018 and early 2019. In comparison with the December projections, the slight upward revision to the growth rate of private consumption reflects the increase in the purchasing power of nominal household income against a background in which, as mentioned above, price increases are more contained than they were forecast to be three months ago. In any case, private consumption is expected to slow gradually, due to a number of different factors. First, as already indicated, the current projections incorporate the assumption that, in an environment of greater global uncertainty, households will tend to raise their savings ratio, which is currently close to its all-time low. Also, the propensity to consume increases in employment income will tend to be lower than in the recent past. This is because such increases derive to a greater extent from rises in real wages than from job creation and the propensity to consume is lower for the former than for the latter. The final factor underlying the projected slowdown in private consumption is the completion of the process of taking the decisions to acquire the durable and semi-durable goods whose acquisition had been postponed during the crisis.

Favourable funding conditions will continue to support the expansionary behaviour of the various components of investment. In particular, residential investment is expected to continue to grow at high rates, driven by buoyant household creation and vigorous job creation. That said, the momentum of this aggregate is expected to gradually decline over the projection horizon.

The growth of business investment will be based on the strength of final demand, the high capacity utilisation and the sustained balance sheet clean-up in the sector. However, this component is also expected to slow somewhat, in line with the reduced strength of final demand and the outlook of continuing moderate export growth, which will limit the investment spending of firms with a high proportion of foreign sales. In comparison with the December projections, the downward revision to this component is more pronounced than for the other components of private demand, since it is affected more directly by the increase in uncertainty in the rest of the world.

The projected improvement in the contribution of the external sector to GDP growth is based on the expected increase in export dynamism. Exports weakened very significantly in 2018, by more than their markets, due to predominantly temporary factors. These include the delayed impact on sales outside the euro area of the euro depreciation in 2017 and the recovery in tourist flows to certain competitor countries in the Mediterranean basin. The disappearance of these effects should allow the market share gains that have been recorded for most of the recovery, as a consequence of the competitiveness gains accumulated since the start of the crisis and the increase in regular exporters, to resume. However, as mentioned when describing the changes to the assumptions, the deterioration in the external environment has led to a downward revision to expected growth in external markets. This is reflected in lower expected export growth than in the December projections. As in December, the import projections incorporate the assumption that the elasticity of this final demand

component will be somewhat higher than during the initial years of the recovery (although lower than in the last two years).

The weakening of GDP growth rates over the projection horizon will be accompanied by a loss of momentum in employment of similar magnitude, except in the short term, when the slowdown in employment will tend to be intensified by the impact of the increase in the national minimum wage at the beginning of 2019. Continued job creation will allow further reductions in the unemployment rate, although their magnitude will be reduced by the rise in the labour force. Current projections envisage a fall in the unemployment rate to 12% by the end of the projection horizon, similar to the level expected three months ago.

On currently available information, the Spanish economy's net lending is expected to fall in 2018 by approximately 1 pp to around 1.2% of GDP, as a result of the decline in real flows of goods and services and the deterioration in the real terms of trade, basically due to the rise in oil prices. During the projection period a further modest decline is expected in the nation's net lending, of 0.5 pp of GDP to 2021, similar to the reduction expected three months ago.

The growth of compensation per employee is expected to be significantly higher during the projection period than in recent years. This reflects the gradual reduction in labour market slack, wage settlements, as at mid-2018, under the collective bargaining agreement for the period 2018-2020 (which recommends annual rises of 2% plus a variable component) and, in 2019, the increase in the national minimum wage. The pick-up in compensation per employee, against a background of continuing low productivity growth, will lead to higher unit labour cost growth rates. Despite the projected containment of profit margins, this will increase domestic inflationary pressures. By contrast, those of external origin, as measured by the import deflator, are expected to weaken in the short run.

Specifically, in terms of consumer prices, the energy component has slowed significantly since the end of last year, due to the fall in oil prices in the latter part of 2018 and the base effects deriving from their previous rise. This trend is projected to intensify during 2019. For the rest of the projection horizon, according to futures prices, the expected path of oil prices has a mildly negative profile. This, combined with the assumptions for electricity prices, is expected to produce rates of change in the energy component of close to zero. Given these developments, the rate of change of the HICP will fall slightly in the short run, increasing gradually thereafter in line with core inflation. Thus, the average annual rate of change of the HICP is expected to be 1.2% in 2019, 1.6% in 2020 and 1.7% in 2021.

The risks to the central growth scenario are on the downside, mainly as a result of external uncertainties. In particular, as already mentioned, the prospects for short-term growth in Spanish export markets have been revised downwards, in line with recent activity data for the world (and, in particular, for the euro area, Spain's main trading partner), and are now less favourable than they were assumed to be three months ago. At the same time, the hypotheses

regarding the future behaviour of Spanish export markets (deriving from the latest ECB staff forecasting exercise) consider that the recent slowdown is temporary and will be reversed in the second half of the year. However, the recent activity weakness, especially in the euro area, could be more persistent, leading to a less favourable performance by the Spanish economy than envisaged in the central scenario.

In addition, a number of risk factors persist that would lead to less favourable developments were they to materialise. Specifically, the lack of clarity regarding the terms of the United Kingdom's departure from the European Union means that certain scenarios that could have very severe consequences for both areas cannot be completely ruled out. Also, uncertainty persists regarding the possible adoption of new protectionist measures at global level that would distort world production and result in the revision of business investment plans. Finally, the Chinese authorities are facing the difficulty of balancing fiscal and monetary stimulus for

the economy, to alleviate the current slowdown, with attempting to halt the rise in the indebtedness of private and public agents.

Domestically, a high degree of uncertainty persists regarding the future economic policy stance and, in particular, fiscal adjustment (which is needed to reduce the high level of public debt that is still one of the main sources of vulnerability for the Spanish economy) and the adoption of measures to raise the long-run potential growth rate. Also, continuation of the current upturn requires that the competitiveness gains relative to the rest of the world achieved in recent years be maintained. It would therefore be desirable for wage rises to reflect the specific circumstances of each firm or sector and, in particular, productivity growth, avoiding general economy-wide increases that bear no relation to such specific conditions. In addition, price and wage setting mechanisms should be sufficiently flexible to allow adaptation, where necessary, to a more pronounced slowdown in activity, so as to limit possible activity and employment losses.

The negative trend of euro area exports contributes notably to explaining the sluggishness of activity observed throughout 2018. The slowdown in exports came about against a background of less buoyant world trade, associated with the loss of momentum in global activity and with the heightening of trade tensions that affected business confidence and investment. For the year on average, global trade (excluding euro area imports) grew by 4%, compared with 5.6% in 2017. Moreover, the rate of increase of this variable weakened notably as 2018 unfolded (excepting a transitory rebound in the central months), with negative rates being posted at year-end, a relatively uncommon phenomenon in the time series (see Chart 1).

This slowdown in world trade has fed through sharply to exports and to the activity of the European economies, with fairly generalised slackness apparent. In the area as a whole, sales of goods targeted on the rest of the world grew by 2% in 2018 (against 4.3% in 2017)¹, with end-year real rates of increase below 1% (in year-on-year terms) and reductions in some countries such as Germany, Italy and Spain. In parallel, output in the industrial sectors, which is generally more export-oriented than that in services, posted moderate growth over the year as a whole.

The high degree of trade openness of the European economies plays a significant role in explaining the impact of the slowdown in world trade on euro area economic activity. As Chart 2 shows, the average degree of openness of the euro area countries (excluding intra-area trade) is far higher than that of the United States and even exceeds that of China. Admittedly, the creation of the euro area has led to greater trade among its member countries; but the rise in exports to markets outside the area has been even greater. Thus, the share of extra-euro exports in total exports increased from 48% in 2000 to 55% in 2018. During this period, there was a notable increase in the weight of exports to Asia (to China in particular) and to the rest of the EU countries not belonging to the euro area (such as Poland, Romania and Hungary), areas whose significance currently exceeds that of other traditional export markets such as the United States and the United Kingdom.²

A key factor behind the weakness of euro area exports in 2018 is the relatively less dynamic behaviour of the economies which, at present, are comparatively more significant in the euro area foreign trade structure in terms of geographical specialisation. Specifically, there has been a contraction in sales to the United Kingdom over the past year, compounding the weakness recorded

since 2016 when the Brexit referendum was held (see Chart 3). Adding to this, in 2018, was the notable slowdown in exports to the rest of the EU, to Russia and to China. At a greater level of disaggregation, there was a notable decline in exports to Turkey (which technically went into recession in late 2018, and saw its currency depreciate sharply) and to other Asian countries, all of which are comparatively important markets for the euro area. Conversely, exports to the United States were robust, despite the trade tensions with this country. The upshot was a significantly sharper easing in euro area foreign demand³ than that observed in global trade (see Chart 4).

Trade specialisation by product may also have checked the growth of exports. In particular, the difficulties the automobile industry has undergone (owing to the adaptation to new emissions rules and uncertainty over the structural transition from diesel to new technologies) have, given their high weight in the euro area's total exports, adversely impacted sales abroad, especially in Germany (which accounts for more than 50% of total euro area car exports). Also, the slowdown in China, in transition towards a growth model based more on consumption and less on investment, has negatively affected euro area exports, given the high weight of capital goods in sales targeted on China (see Chart 5).

Lastly, a further factor that may have curbed export growth in 2018, especially in the first half of the year, is the euro appreciation in nominal effective terms against its trading partners in 2017.⁴ That would explain why the easing in extra-euro area exports was, generally, sharper than that recorded by the respective export markets. This loss in share was across the board, with the exception of France, whose sales abroad trended somewhat more favourably than the attendant foreign demand (see Chart 6).

In short, the high degree of openness of the euro area economies, along with the geographical orientation and the product-based specialisation of their exports, has made the euro area particular sensitive to external shocks and to the slowdown in world trade. Looking ahead, the uncertainty over the possible escalation in protectionist measures paints a complex picture for European exports, especially in a setting, such as the present, marked by worsening global economic prospects. Among the most significant factors are the findings of the research by the US authorities on car imports from Europe, which might see higher tariffs on this type of product, and the hypothetical effects of diverted trade which a future bilateral trade pact between China and the United States could have on the euro area.

¹ Cumulative growth in the year, with data to November 2018.

² The composition of exports evidences other differences from country to country. Specifically, while in Italy and in France the weight of extra-euro area exports stands at around the average, in Germany it is higher (63%), and in Spain and Portugal lower (47% and 35%, respectively). There are also differences when specific destinations are considered: in Germany, exports to China have a greater weight (at the expense of Africa and the Middle East); and in Spain, Latin America, Africa, the Middle East and the United Kingdom are more important, and the United States, emerging Asia and other EU countries less so.

³ Euro area foreign demand is obtained by weighting the imports from different world regions (based on the Central Planning Bureau series), taking the weight of sales to each of them in extra-euro area exports.

⁴ The econometric models available suggest that exchange rate movements take between three and four quarters to be reflected in the behaviour of exports. Hence, it is estimated that the appreciation of the euro in 2017 had an adverse impact on export growth in 2018, and a virtually zero effect in 2017.

Chart 1
GLOBAL GOODS IMPORTS EXCLUDING EURO AREA. ANNUAL AND QUARTERLY CHANGE, AND CONTRIBUTIONS

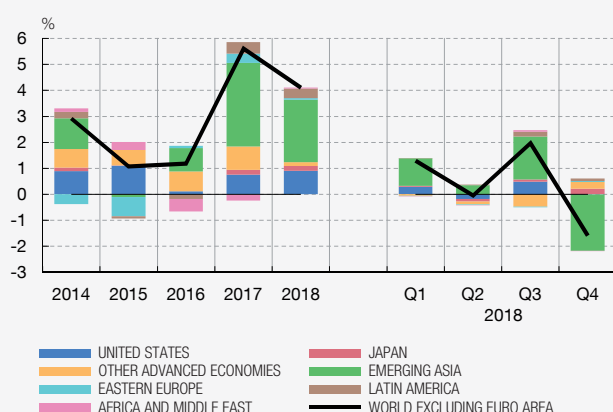


Chart 2
DEGREE OF TRADE OPENNESS (2017) (a)

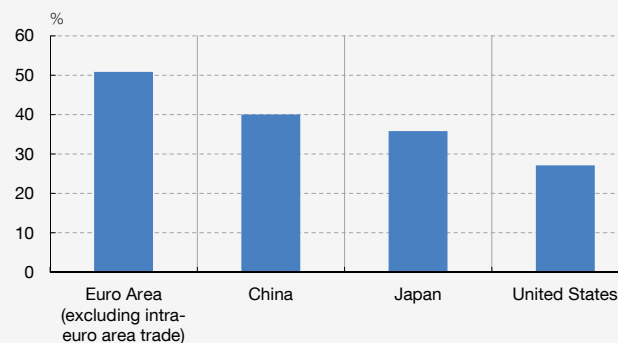


Chart 3
REAL EXTRA-EURO AREA GOODS EXPORTS. ANNUAL CHANGE AND CONTRIBUTION

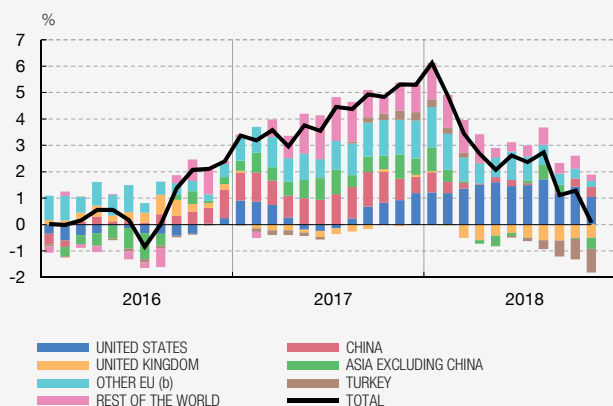


Chart 4
EXTRA-EURO AREA GOODS EXPORTS, EXTERNAL DEMAND AND GLOBAL IMPORTS. REAL TERMS

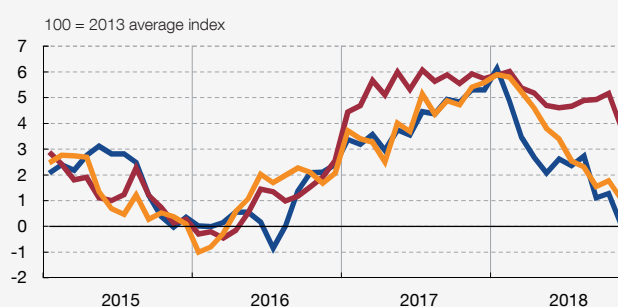


Chart 5
REAL EXTRA-EURO AREA GOODS EXPORTS. ANNUAL CHANGE AND CONTRIBUTION BY TYPE OF PRODUCT

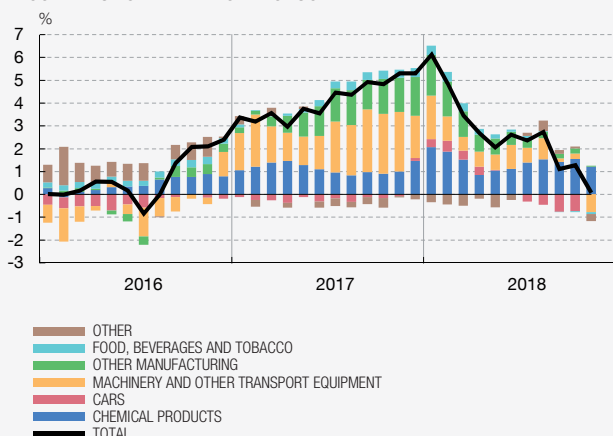
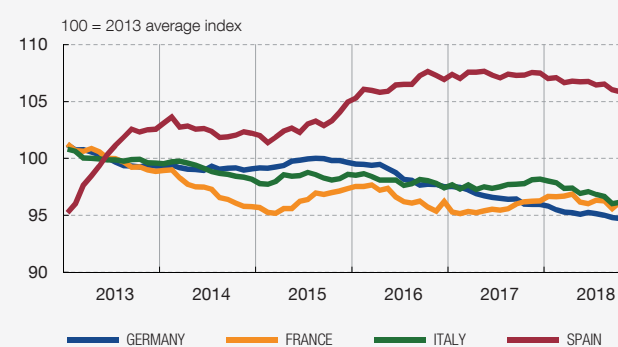


Chart 6
EXTRA-EURO AREA GOODS EXPORT MARKET SHARES (c)



SOURCES: Banco de España, World Bank, Central Planning Bureau, Eurostat and World Trade Organization.

a Exports plus imports of goods and services as a percentage of GDP.

b Other EU refers to EU countries (Denmark, Sweden, Poland, Hungary and Romania) that do not belong to the euro area, except United Kingdom.

c Extra-euro area export market share is the ratio of the extra-euro area exports of each country to its euro area foreign demand.

The real estate market is key to explaining cyclical developments in the US economy. Nine of the 11 recessions experienced in the United States since the Second World War have been preceded by a significant slowdown in the housing market.¹ Against this background, and especially bearing in mind the still-fresh memory of the role of this market in the origins of the 2008 economic and financial crisis, the real estate slowdown of late is arousing some concern. This box assesses the scale of the recent loss of momentum in the US housing market and its determinants. Its aim is to shed light on its relevance as a factor of risk for the prolongation of the US economy's current upturn.

Residential investment has in fact been slowing continuously in recent years, currently posting practically zero growth rates (Chart 1). This reduction in the contribution of housebuilding to GDP growth has been accompanied by a continuing upward path of house prices (Chart 2). There are certain demand factors behind this diminished activity in the residential market. Admittedly, the sound behaviour of the labour market, in terms of the decline in the unemployment rate to historical lows and sustained wage growth, is a powerful source of support for house purchases. But opinion-based surveys show that consumers do not think the current moment is a good one for buying a house.²

Part of the explanation lies in the consequences of monetary policy normalisation for the cost of mortgage financing. And this has been reflected in the lower pace of house sales and of the flow of new credit. As Chart 3 shows, since late 2016 the fixed interest rate on 30-year mortgages (the most usual form of financing in the US market³), has risen by more than 100 bp to around 4.5%. If price developments are added to the cost of financing, the outcome is that the housing affordability index is in its most unfavourable position since the financial crisis broke (as the blue line in the chart shows). In addition, the 2017 tax reform (the Tax Cuts and Jobs Act) has contributed to making house purchases dearer by limiting the maximum amount of tax-deductible mortgage expenses. Buyers with lower incomes or with fewer savings for the initial down payment have seen their access to the market limited as the stricter lending standards in force in the wake of the crisis have become binding for a higher proportion of potential buyers. In the case of the youngest cohort, a further factor limiting home buying possibilities is the worsening of their credit ratings as a result of the rapid rise in the outstanding balance of student debt (Chart 4).⁴

True, the loss of dynamism in the US residential market is essentially in response to demand-side factors. But these have been compounded by various supply-related factors. First, there

has recently been a notable increase in construction costs, which have coincided with the scarcity of skilled labour in the sector.⁵ Second, tighter land use regulations have, along with building constraints, contributed to the shortage of plots available for house building and to making them dearer, particularly in areas closest to city centres.⁶ The upshot has been the stagnation of housing starts and the slowdown in residential investment spending (see Chart 5). Moreover, the construction of new housing has tended to be concentrated in the dearest market segment, that which continues to have the highest returns.⁷ Hence, despite the slowdown in demand, new houses placed on the market do not cover the existing demand in this segment, and the overhang of housing stock has fallen to historically low levels (see Chart 6).

Supply shortages have translated into price increases which, since 2012, have persistently outgrown household incomes (Chart 5). But, moreover, supply/demand mismatches tend to exacerbate the heterogeneity of the different market segments. This is particularly so at the regional level, which is more pronounced than in other countries, owing to the strong domestic migratory flows towards cities and, especially, towards metropolitan areas on both coasts. As a result, prices are very uneven. Some geographical areas have accumulated rises in excess of 180% since 2000, coexisting alongside others where this increase is below 25% (see Chart 7).

Looking ahead, the prospect of the recent downturn in the residential market leading to a sharp correction, such as that in the wake of the financial crisis, appears limited. This is because there are marked differences between the current situation of the residential market and that of the previous cycle. Firstly, at least at the national level, the rates of construction of new houses and of household formation are aligned, denoting that, unlike the previous cycle, the dynamics of the residential sector are underpinned by fundamentals and are, therefore, more sustainable. Secondly, the adjustment of the sector following the crisis has meant that its weight in US GDP is much less compared with the previous cycle. That restricts the scale of the impact of any downturn in activity in this sector on the rest of the economy. Specifically, the weight of residential investment in GDP currently stands below 4%, somewhat down on the historical average (of 4.6% since 1951), and clearly below the high of 6.7% attained at the height of the previous real estate cycle. Thirdly, household debt is now much more moderate. Compared with the pre-crisis high, the total and mortgage debt of households as a percentage of their disposable income has respectively fallen by around 30 pp to 102% and 59% (Chart 4). Moreover, the sector's aggregate balance sheet has been significantly restructured during the lengthy expansion and mortgage debt is now concentrated in those groups of households with less credit risk (Chart 8). Finally, the financial regulation

1 See Leamer, E., 2007. "Housing is the business cycle," Proceedings - Economic Policy Symposium - Jackson Hole, Federal Reserve Bank of Kansas City, pages 149-233.

2 As indicated in the [University of Michigan house buying conditions index](#).

3 American Bankers Association, "24th Annual ABA Residential Real Estate Survey Report", March 2017.

4 Federal Reserve, "Consumer & Community Context", January 2019.

5 See the latest editions of the Federal Reserve's [Beige Book](#).

6 See Brookings Institution, "The Goldilocks problem of housing supply: too little, too much, or just right?"

7 See Urban Land Institute and PWC, "Emerging Trends in Real Estate 2019".

Chart 1
RESIDENTIAL INVESTMENT



Chart 2
GROWTH OF HOUSE PRICES AND PERSONAL DISPOSABLE INCOME



Chart 3
AFFORDABILITY



Chart 4
HOUSEHOLD DEBT

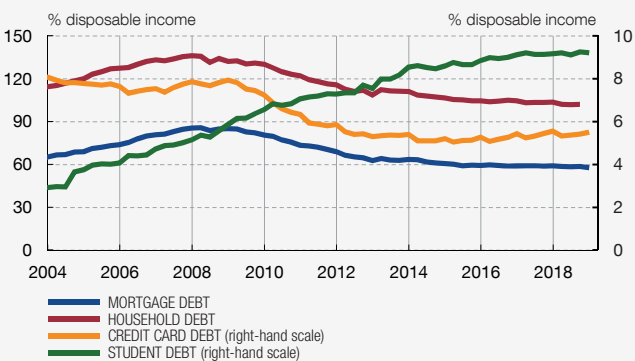


Chart 5
CONSTRUCTION CONFIDENCE INDEX, HOUSING STARTS
AND CONSTRUCTION EXPENDITURE



Chart 5
HOUSING STOCK

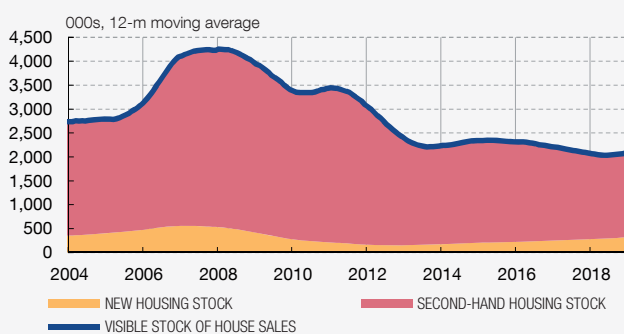


Chart 7
HOUSE PRICE INDEX

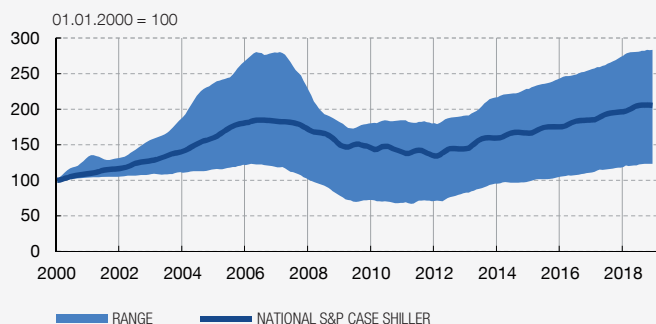
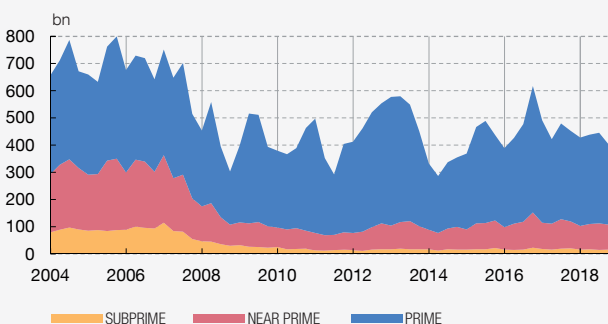


Chart 5
MORTGAGE LOANS GRANTED ACCORDING TO HOUSEHOLD CREDIT RATING



SOURCES: Bureau of Economic Analysis, Standard & Poor's, Office of Federal Housing Enterprise Oversight, NAR - National Association of Realtors, Bloomberg, Federal Reserve, Federal Reserve Bank of New York, U.S. Census Bureau, University of Michigan and MBA - Mortgage Bankers Association of America.

changes introduced after the crisis have tightened the requirements on mortgage loan collateral and on the financial derivatives created from such mortgages. That has mitigated the risks to national and global financial stability of a correction in the US housing sector.⁸

⁸ Federal Reserve, “[Financial Stability Report](#)”, November 2018.

In sum, the housing market is significant for the US economy as a whole. Its possible implications for financial stability, along with the habitual difficulty of anticipating potentially sharp changes in the real estate cycle, warrant the growing attention and ongoing monitoring of conditions in this market by analysts and official institutions.

On 13 December, the ECB Governing Council announced the end of net asset purchases at the close of 2018 and re-emphasised its reinvestment policy for instruments acquired under its asset purchase programme (APP). Specifically, the Council stated it envisages fully reinvesting the principal payments from maturing securities “for an extended period of time past the date when it starts raising the key ECB interest rates”. At the same meeting, the Council maintained its expectations that these rates would hold at their current levels “at least through the summer of 2019”, lengthening this term to “at least through the end of 2019” at its latest meeting on 7 March.¹

Against this background it is worth analysing first, how market expectations about the future course of the ECB benchmark

interest rate have recently behaved; and further, how the future path of rates currently expected by the markets compares with that observed in past episodes in which the ECB and the US Federal Reserve initiated cycles of interest rate rises.

As Chart 1 shows, market expectations about the future course of the ECB's benchmark interest rate (the deposit facility rate), proxied by the EONIA² instantaneous forward curve, have been revised downwards notably in recent months. In October 2018 the markets were discounting 10 bp increases in interest rates in the following 12 months (see green curve in Chart 1), thereby pencilling in the first rise for October this year. However, they now envisage

1 See: Monetary policy decisions, ECB press releases of 13 December 2018 and of 7 March 2019. At its meeting on 7 March, the Governing Council also agreed on a new series of quarterly targeted longer-term refinancing operations (TLTRO-III).

2 EONIA (Euro Overnight Index Average) is the average overnight interbank interest rate in the euro area. Since 2009, the behaviour of the EONIA index has been very similar to that of the ECB's deposit facility rate, which is currently the benchmark rate for euro area monetary policy. Also, it should be borne in mind that forward rates, especially for longer-dated horizons, may incorporate risk premia in addition to future expectations about interest rates.

Chart 1
LEVEL OF EXPECTED RATES IN THE EURO AREA WITHIN N MONTHS

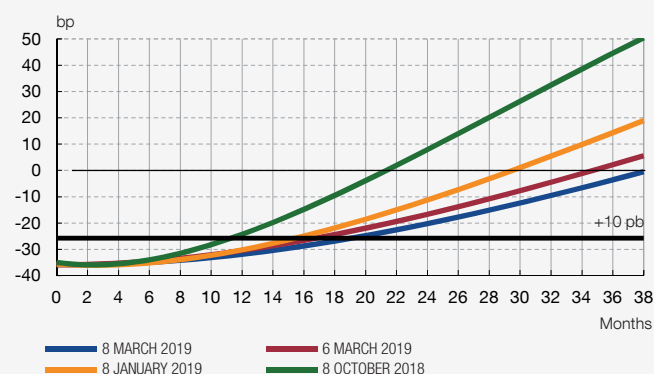


Chart 2
EXPECTED AND ACTUAL INCREASE IN EURO AREA RATES IN N MONTHS AS FROM THE FIRST RISE

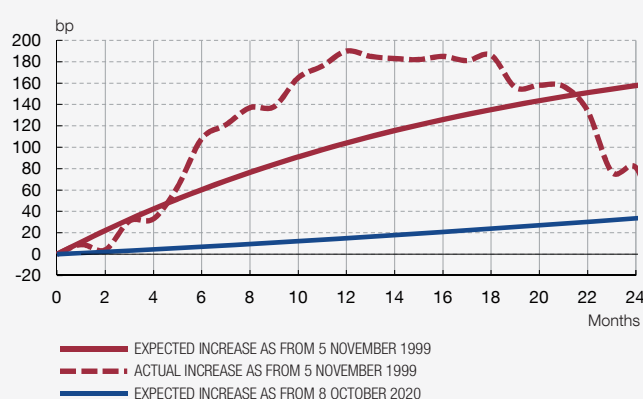


Chart 3
EXPECTED AND ACTUAL INCREASE IN EURO AREA RATES IN N MONTHS AS FROM THE FIRST RISE

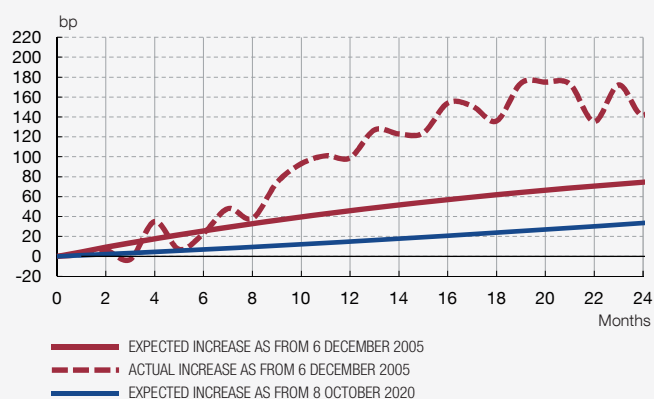
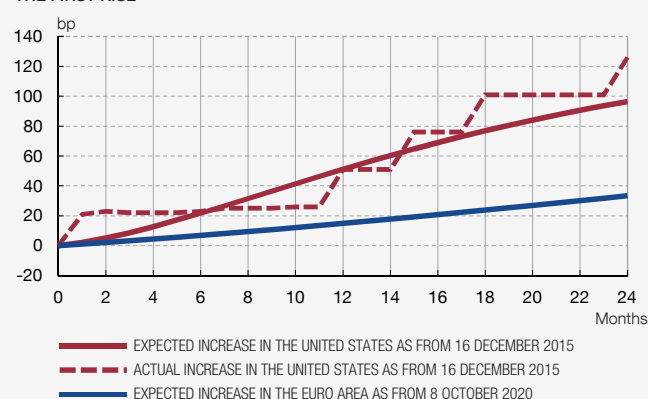


Chart 4
EXPECTED AND ACTUAL INCREASE IN RATES IN N MONTHS AS FROM THE FIRST RISE



SOURCES: ECB, Federal Reserve and Datastream.

NOTE: The data on expected rates are obtained calculating the instantaneous forward curve based on OIS (overnight index swaps). The actual interest rate is the EONIA index for the euro area and the Fed Funds Rate for the United States.

this rise taking place within 19 months (see blue curve in Chart 1), which means a delay until October 2020 (assuming that this first rise were to be one of 10 bp). Essentially behind this change has been the worsening outlook for global growth observed in late 2018, most markedly so for the euro area. But another factor has been the recent change in the minimum time horizon over which the ECB Governing Council expects to maintain its policy interest rates at current levels, announced on 7 March this year along with a downward revision of the growth and inflation projections for the euro area in the coming years. Following these announcements, the date foreseen by the markets for the first rise in rates was set back by three months compared with what the markets had anticipated just before learning of the measures adopted at the last ECB Governing Council (see the red and blue curves in Chart 1).

Beyond the delay in the start of the cycle of euro area policy interest rate rises, Chart 1 shows how market expectations about the intensity of any future process of rises in these interest rates may have been considerably modified in recent months. In particular, if in early October 2018 the EONIA instantaneous forward curve anticipated that the euro area benchmark interest rate would turn positive as from August 2020 (22 months later), the flattening of this curve in the recent period indicates that the market foresees interest rates not moving into positive territory before 2022 (within 38 months).

The high gradualism the markets expect of the future path of euro area interest rate rises is in contrast to the behaviour of these rates in the past two episodes in which the ECB initiated cycles of interest rate rises (1999 and 2005)³. It also runs counter to the expectations the markets had about future rises at the time of the first increase in rates in these episodes. Currently, the EONIA instantaneous forward curve is discounting a 34 bp increase in the euro area benchmark rate in the two years following the first rise (October 2020) (see the blue line in Charts 2 and 3). That is below the 158 bp and 75 bp increases the markets were anticipating at the time of the first rise in rates in the 1999 and 2005 tightening episodes, respectively (see the unbroken lines in red in Charts 2 and 3), and less than the respective

rises of 85 bp and 141 bp actually observed (see the broken lines in red in Charts 2 and 3⁴).

Current euro area policy interest rate expectations are also in contrast to the intensity of the ongoing normalisation in the United States since the Federal Reserve raised its policy rates for the first time in this cycle in December 2015. Two years after this first rise, US benchmark rates rose by 126 bp, an increase very close to that expected by the markets in December 2015 (96 bp), but far above the current expectations in the euro area (see Chart 4). Yet in recent months the mounting signs of moderation in the US economy's growth rate has prompted the Federal Reserve to revise the path of interest rate normalisation.⁵ Indeed, at present, the markets expect US policy rates to stand in the short and medium term below the levels they anticipated only a few months back.

In conclusion, the recent macroeconomic downturn and the announcement of the extension of the minimum time horizon over which the ECB expects to maintain its policy interest rates at current levels has prompted the markets to significantly put back the envisaged date of the start of interest rate rises in the euro area. Moreover, the markets currently anticipate that, following that first rise, the path of subsequent increases will be very gradual, both in historical terms and compared with movements in the United States from 2015 to late 2018. The downward revision in recent months in interest rate expectations shows that the ECB's forward guidance policy has been effective in steering financial market expectations, by making the future path of interest rates conditional upon the economic situation and the inflation outlook. This forward guidance should contribute to mitigating the scale of the slowdown in activity insofar as it promotes, through the adjustment of market expectations, easier financial conditions.

³ Moreover, the ECB increased its benchmark interest rate on two occasions in 2011, in March and in July. That said, this cycle of rises was interrupted in November that same year when the decision was taken to cut the interest rate once more.

⁴ In the charts, the EONIA instantaneous forward curve is normalised so that it commences with an interest rate equal to zero at three different points in time: the present (showing the curve 19 months ahead) and at the start of the ECB monetary policy tightening periods in 1999 and 2005. Significantly, both in 1999 and in 2005, the euro area benchmark interest rates corresponded to those on the main refinancing operations (MRO), the behaviour of which was in turn very similar to the EONIA.

⁵ At the press conference following the latest FOMC meeting in late January, at which it was decided to hold policy rates unchanged, the Fed chairman Jerome Powell warned of the need to be patient regarding changes in interest rate policy. This message remains valid, since the Fed chairman suggested in an interview on Sunday, 10 March, that he did not feel any hurry to change the current interest rate policy.

On 21 February 2019, the Congress of Deputies approved the Law regulating real estate credit agreements (the Law), which is due to be published in the *Boletín Oficial del Estado* (Official State Gazette) in the next few days and to come into force three months thereafter. The Law, which will then apply to new mortgage agreements and, in certain specific cases, to outstanding agreements, transposes Directive 2014/17/EU¹ into Spanish law. This directive regulates customer protection, transparency and conduct in relation to credit agreements for the acquisition of residential real estate. The Law also contains other provisions not specifically envisaged in the directive, which further strengthen borrower protection in certain areas. This box summarises the main features of this law and analyses its possible effects on the mortgage market.

The Law introduces highly detailed rules for the pre-contractual stage, requiring lenders to provide borrowers with information on the content of agreements through the European Standardised Information Sheet, which will be considered to be a binding offer, and a standardised warning sheet including information on the most important clauses and features of the agreement. At the same time, notaries are assigned a more important role, being required to ensure that customers have been provided with all the necessary information within the periods laid down and to provide advice on the content of the agreement. The content of the notarised deed will be considered

evidence of such advice and of the borrower's understanding and acceptance of the content of the documents delivered, for the purposes of substantive compliance with the principle of transparency. The property registrar, meanwhile, will refuse to register those clauses of agreements that are contrary to legal provisions or that have been declared null and void by the Supreme Court.

Also, a number of rules are introduced on the conduct and internal organisation of lending institutions, requiring the solvency of the borrower to be assessed before and during the life of the loan, the remuneration of the lender's staff not to be linked to the volume of credit transactions (to avoid adverse incentives) and a general ban on tying practices. Moreover, unlike at present, when most of the expenses related to the loan agreement tend to be borne by the borrower, after the entry into force of the Law, the agency, notary and registration fees will be payable by the lender, the borrower bearing only the appraisal fees and the cost of any copies requested of notarised documents.²

The regulations currently in force limit only the maximum fees for early repayment (i.e. when the customer repays all or part of the outstanding debt early) in the case of variable rate agreements. As seen in Table 1, the Law reduces these maximum fees from 0.5% or 0.25% of the repaid principal, according to whether the repayment takes place during the first five years of the loan or thereafter, to 0.25% during the first three years (or alternatively 0.15% during the first five years, depending on what the parties

¹ Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

² Stamp tax is also payable by the lender, following the entry into force of Royal Decree Law 17/2018.

Table 1

	Life of the loan (years)	Current regulations (%)	New law (a) (%)	
Maximum fees for:				
Change from variable to fixed rate	0-3	0.50	0.15	
	3-5	0.50	0.00	
	Over 5	0.25	0.00	
Early repayment on fixed interest rate loans	0-10	(b)	2.00	
	Over 10	(b)	1.50	
			3 years (c) (%)	5 years (c) (%)
Early repayment on variable interest rate loans	0-3	0.50	0.25	0.15
	3-5	0.50	0.00	0.15
	Over 5	0.25	0.00	0.00

SOURCE: Law regulating real estate credit agreements.

a Fees may not exceed the financial loss caused to the lender.

b The fees applied shall be those agreed by the two parties. In the absence of an agreement, the fees shall be the amount of the financial loss to the lender.

c Term agreed for charging of fees.

agreed) and 0% thereafter. The Law also introduces maximum limits for early repayment fees in the case of fixed rate loans (2% of the repaid principal during the first 10 years of the loan, and 1.5% thereafter).³ The higher fees in the case of fixed rate loans are justified by the financial loss lenders may incur in the event of early repayment. This loss arises when the market interest rate falls below the mortgage rate, since the interest that the lender would have received during the residual life of the loan will be

greater than the market return available on similar assets when the repaid funds are reinvested. As seen in Chart 1, this loss basically depends on the residual maturity of the mortgage, the (positive) differential between the mortgage rate and the market interest rate and, albeit to a lesser extent, the level of market returns.⁴ This chart also shows that the maximum limits established by the new regulations (the dotted lines) would in some cases not fully cover

3 In any event, the amount of fees may not exceed, either in the case of fixed rate loans or in that of variable rate loans, the financial loss caused to the lender.

4 Chart 1 shows the present value of future losses for the institution, obtained using a discount factor that depends on the market interest rate. The higher the market interest rate the more future losses are discounted and thus the lower their present value.

Chart 1
LOSS FOR THE LENDER ASSOCIATED WITH EARLY REPAYMENT UNDER FIXED RATE LOANS ACCORDING TO THE DIFFERENCE BETWEEN THE MORTGAGE RATE AND THE MARKET RATE, THE MARKET RETURN AND MATURITY

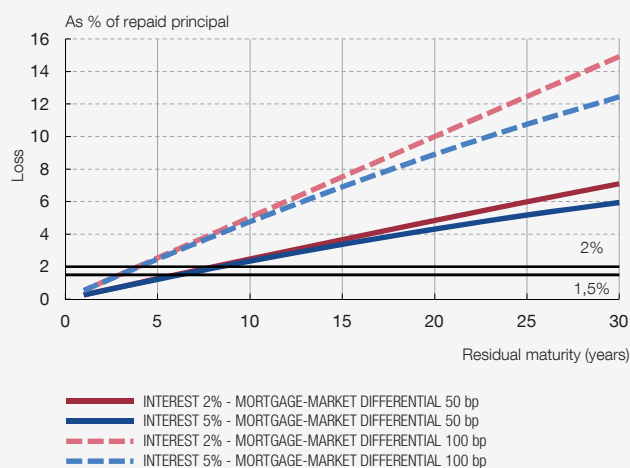


Chart 2
NUMBER OF PAST-DUE MONTHLY INSTALMENTS TO REACH THE 3% LIMIT ACCORDING TO THE INTEREST RATE APPLIED, RESIDUAL MATURITY AND PROPORTION OF LOAN REPAYED

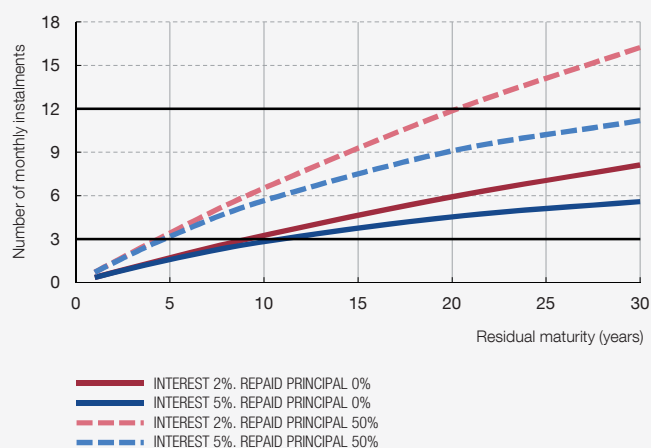


Chart 3
NUMBER OF PAST-DUE MONTHLY INSTALMENTS TO REACH THE 7% LIMIT ACCORDING TO THE INTEREST RATE APPLIED, RESIDUAL MATURITY AND PROPORTION OF LOAN REPAYED

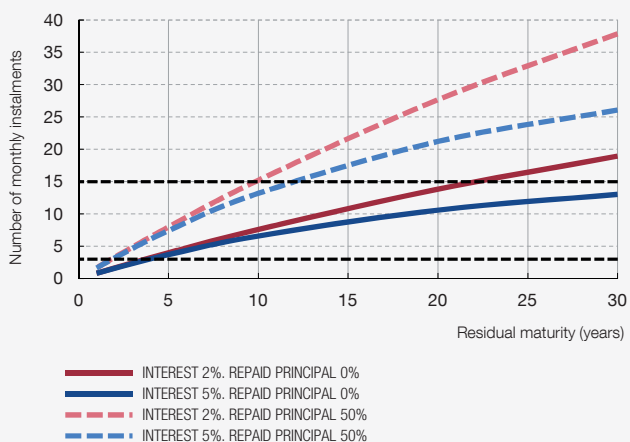
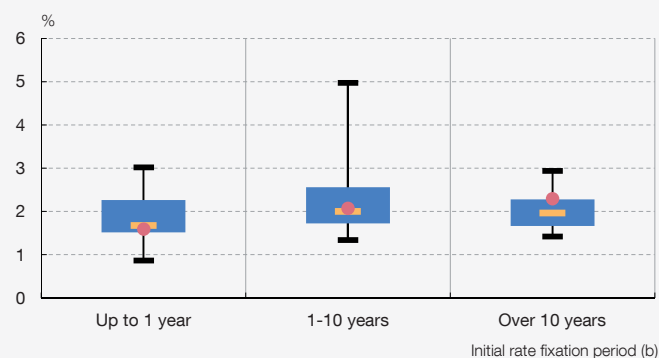


Chart 4
DISPERSION OF MORTGAGE RATES IN THE EURO AREA (a)



SOURCES: ECB and Banco de España.

- a Average rates on new lending in December 2018 for each country.
b Period for which the fixed rate at origination is maintained.

the financial loss suffered by the lender in the case of fixed rate loans.

The Law also regulates acceleration, namely the right of the lender to terminate the agreement in the event that the borrower has failed to pay a certain number of loan instalments, as a prior step to realising the collateral. Specifically, it establishes that in order for the lender to be able to exercise this right during the first half of the life of the loan the unpaid instalments must exceed 3% of the loan principal or 12 monthly instalments or, during the second half of the loan, 7% of principal or 15 instalments. Further, the lender must have requested the borrower to pay the outstanding amount, while granting the latter a period of at least one month in which to do so. These provisions will not only apply to new agreements but also to existing mortgages with acceleration clauses, unless the debtor alleges that the clause is more favourable to it or that the right to terminate arose before the entry into force of the Law. As seen in Chart 2 (for the first half of the life of the loan) and Chart 3 (for the second half), the number of unpaid instalments necessary to reach 3% or 7%, respectively, of the loan principal, which gives the lender the right to terminate, depends on the interest rate, the residual maturity of the mortgage and the amount of the loan already repaid. In most cases, this number of monthly instalments is clearly more than three (the dotted line in the charts), the number usually specified in mortgage clauses as the requirement for acceleration.⁵ As a result, the Law will generally lengthen the time taken to recover past-due amounts in the case of non-performing loans.

Lastly, the law introduces incentives for the subrogation (change of institution) and novation (change in the terms and conditions of the mortgage with the same institution) of loans when a variable rate mortgage is converted into a fixed rate one (see Table 1). Specifically, maximum fees are established that are lower than those generally charged for early repayment of variable rate loans: 0.15%, during the first three years (as opposed to 0.25% when the fees are set for a period of three years) and 0%, subsequently (as opposed to 0.15% between the third and fifth years when the fees are set for a period of five years). These limits are also lower than those currently in force (0.5% during the first five years and 0.25% thereafter). These reforms will apply to both new and existing loans.

The approval and forthcoming entry into force of the new Law may have various effects on the mortgage market. First, the introduction of binding clauses (as in the case of acceleration and early repayment), along with the increase in information available to customers during the pre-contractual stage, can be expected to

contribute to reducing legal uncertainty and the currently high level of litigiousness in this market, which should lead to more lending and an improvement in the functioning of the mortgage segment.

Moreover, the greater transparency and standardisation of the information available on agreements and the lowered transaction costs associated with a change in lender may raise the competition from both domestic and European operators. As regards the latter, it should be noted that one of the objectives of the directive was to increase the integration of European mortgage markets. In any event, given that notable cross-country differences still persist between the law applicable in this area and, moreover, as seen in Chart 4, Spain is not among the countries with the highest levels of interest rates in most segments,⁶ the effects on the cost of borrowing associated with greater integration of these markets at the European level can be expected to be moderate.

At the same time, the increase in the mortgage costs borne by lenders and, in particular, the maximum limits on early repayment fees in the case of fixed rate agreements may lead to a certain increase in the rates charged on new loans, especially in the case of those applied to the latter type of agreement.

The delay in the recovery of past-due debt for lenders may result in a certain tightening of lending conditions, especially those for debtors with a higher risk profile. Also, the stricter borrower solvency assessment requirements may exacerbate these latter effects, while being conducive to an improvement in the quality of institutions' loan portfolios. In any case, the final impact of the Law on mortgage financing conditions will also depend on the effects in the opposite direction associated with the possible increase in competition and the reduction in legal uncertainty.

Finally, the greater ease with which variable rate loans can be converted into fixed rate ones may encourage a shift in the stock of debt towards fixed rate agreements, reducing the high current weight of variable rate mortgages.⁷ This would lead to a transfer of interest rate risk from debtors to creditors, who are in principle in a better position to manage such risk. However, the extent of this effect will depend on debtors' risk/cost preferences, i.e. the extent to which, in order to secure a fixed rate of interest over the life of the loan, they are prepared to incur a higher expected cost, reflecting an interest-rate risk premium and a premium associated with the possibility of early repayment.

⁵ Current legislation does not regulate acceleration, but most outstanding agreements include acceleration clauses that generally give the lender the right to terminate when three instalments remain unpaid.

⁶ As at the reference date of the chart, the percentages of the amount of new transactions in Spain by maturity were: 35% up to one year, 32% between one and 10 years and 33% over 10 years.

⁷ Fixed rate transactions account for only around 10% of the total stock of loans, although in recent years there has been an increase in this type of loan in new lending.

In the current expansionary phase the Spanish economy has shown robust job growth, the current level of which increased in 2018 for the fifth year running. This dynamic is allowing a notable part of the unemployment generated during the crisis to be absorbed.¹ The persistence of a sufficiently long period of net job creation allows us to analyse gross job creation and destruction and thus examine possible changes in them compared with the crisis period and particularly with the latter years of the previous expansion. This box addresses this question through a descriptive analysis of employment inflow and outflow rates using flow information from the Spanish Labour Force Survey (LFS),² paying particular attention to the breakdown by type of contract (temporary or permanent).

Chart 1 shows, along with the year-on-year change in GDP, the job creation rate proxied by the ratio of total employment inflows in a quarter to the total unemployed and economically inactive population in the previous quarter (i.e. the probability that a person who is not working will become employed in the following three months). As can be seen, after touching bottom in 2013 at around 5.8%, the job creation rate exhibited a rising trend until mid-2017, holding relatively steady since then at around 6.5%. True, this percentage is lower than before the crisis, when it exceeded 8%; but it should be kept in mind that this is basically because the unemployed and economically inactive population (i.e. the denominator of the ratio) is larger at present, while the number of jobs created is, in gross terms, similar to that in the years before the recession.³ Indeed, the pace of job creation would even be somewhat higher in the current recovery if it were taken into account that GDP growth, which drives job creation, is currently somewhat lower than in the two years preceding the onset of the crisis.

As regards the flows from employment to unemployment, the probability of becoming unemployed, as measured by the ratio of the people who lose their job in a quarter to the total employed in the previous quarter, has fluctuated more sharply in the recent period. Specifically, after increasing markedly at the height of the recession, this variable trended downwards from 2013, to stand at 3.3% at end-2018 (see Chart 2). However, although this rate is the lowest in the last 10 years, it is still nearly 1 pp higher than in the two-year period from 2006 to 2007. Also, in step with the definition of the job creation rate described above, if the outflows from employment were to take into account a transition to non-employment status which included not only unemployment but also inactivity, the job destruction rate would currently be similar to that in the pre-crisis period (see Chart 3).

Analysis of employment inflows by type of contract shows that the proportion of new labour market entrants under a temporary

contract increased between 2009 and 2015, in line with the greater incentives firms have to opt for this type of contract in situations of high uncertainty (see Chart 4). This trend was, moreover, accompanied by a significant decrease in conversions of temporary workers into permanent ones (see Chart 5). Subsequently, despite the economic recovery having become more firmly entrenched, the proportion of temporary workers in employment inflows showed no signs of moderating, remaining steady at a slightly higher level than in 2006. What was observed, by contrast, was a rise in the percentage of temporary jobs being converted into permanent ones from 2017 onwards. Yet this percentage stood at 8% at end-2018, a level clearly lower than that before the crisis, when it reached values near 13%.⁴ The downward stickiness of the proportion of temporary jobs in employment inflows is apparent, to a greater or lesser extent, in all of the five main economic sectors analysed,⁵ although it is somewhat more marked in construction than in the others. Moreover, in all economic sectors the rate of conversion of temporary workers into permanent ones was lower in 2018 than in 2006, particularly in private-sector services and industry. In construction it rose last year, approaching the level of 2006.

Temporary workers are also those hit hardest by job destruction. Chart 6 shows that the ratio of temporary employees to wage-earners who became unemployed was lower during the crisis than at the end of the previous upturn. This phenomenon is consistent with the increase in probability of dismissal which, regardless of contract type, can be expected at the height of a recession. At the beginning of the current expansion, this percentage again grew, as is customary in cyclical upturns, until it steadied in 2016. Since then it has remained at a level similar to that of 2006, doing so across-the-board in all economic sectors.

In conclusion, the current expansion has not wrought major changes in job creation and destruction with respect to those seen in 2006-2007, i.e. at the end of the previous upturn, after taking into account the GDP growth rate and the levels of the employed, unemployed and economically inactive populations in both periods. Both processes continue to be underpinned basically by temporary employment. Meanwhile, the creation of permanent jobs, and particularly temporary-to-permanent conversions, which were low in the previous expansion, seem to have decreased even more in the latest crisis and subsequent recovery, although these conversions have risen in the last two years. Thus, despite extensive regulatory changes throughout the period in question, the Spanish labour market continues to feature excess job temporariness and churn. This has an adverse impact not only on productivity but also on the inequality of employment income. It may thus be advisable for permanent contracts to be made more attractive, without that being to the detriment of job creation.

1 In 2018, employment grew by 2.7%, similar to the rate in the previous two years. See the *Nota Económica* entitled “La evolución del empleo y del paro en 2018, según la Encuesta de Población Activa”, Banco de España (only in Spanish).

2 All the flows represented were calculated at the Banco de España from INE microdata and are expressed as four-quarter moving averages to eliminate seasonal movements, which are extremely pronounced.

3 Thus the job creation rate in the current recovery would be similar to that of the pre-crisis years if, alternatively, it were calculated as the flow of new employment divided by the stock of employment in the previous year, given that this latter variable now stands at a level similar to that of 2006-2007 (see Chart 3).

4 Up to mid-2006, temporary-to-permanent conversions were moreover favoured by the widespread tax rebates they enjoyed, which were eliminated in the labour market reform approved in mid-2006. Subsequently some rebates for certain types of contracts remained in force, such as those for apprenticeships, although they made up a scant share of the total jobs created.

5 Agriculture, industry, construction, public services and private services.

Chart 1
AVERAGE RATE OF JOB CREATION AND GDP



Chart 2
AVERAGE RATE OF JOB DESTRUCTION AND GDP

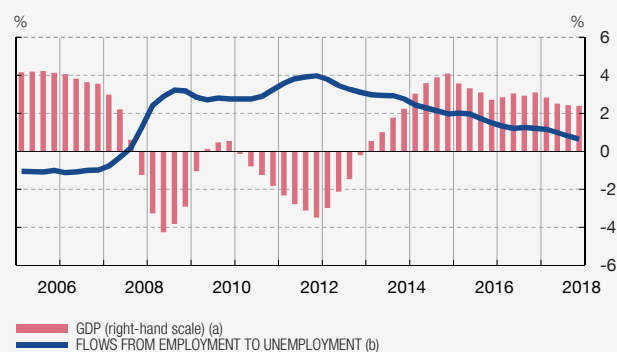


Chart 3
JOB CREATION AND DESTRUCTION FLOWS AS % OF EMPLOYMENT AT T-1 (c)



Chart 4
INFLOWS INTO TEMPORARY EMPLOYMENT FROM NON-EMPLOYMENT. AS % OF TOTAL INFLOWS INTO DEPENDENT EMPLOYMENT (d)

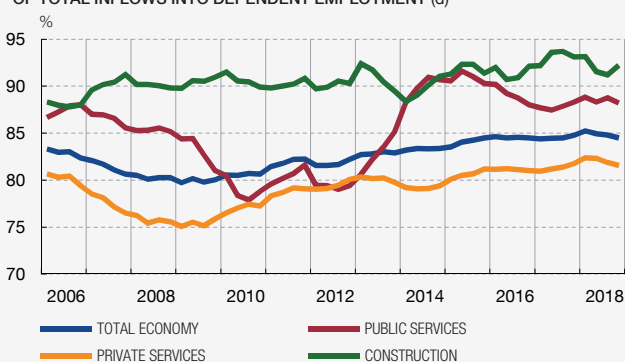
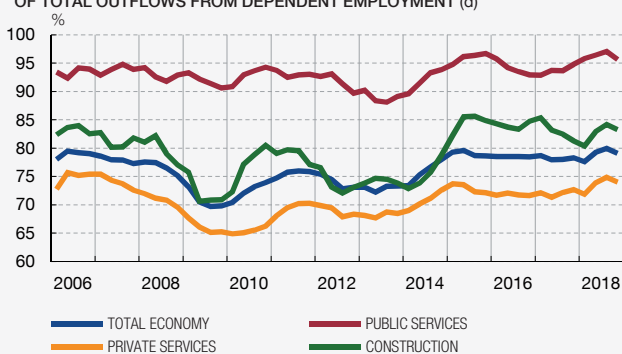


Chart 5
CONVERSIONS FROM TEMPORARY TO PERMANENT EMPLOYMENT



Chart 6
OUTFLOWS FROM TEMPORARY EMPLOYMENT TO UNEMPLOYMENT. AS % OF TOTAL OUTFLOWS FROM DEPENDENT EMPLOYMENT (d)



SOURCES: INE and Banco de España.

a Year-on-year rate of change of the seasonally adjusted series.

b As a percentage of population of origin. Four-quarter average.

c Job creation or destruction flows (in persons) as a percentage of official employment at $t - 1$. Four-quarter average.

d Flows (in persons) of total temporary workers or in an economic sector, as a percentage of the related flow of wage earners. Four-quarter average.

Economic activity in the euro area lost momentum in 2018. It was chiefly affected by the worse performance of global demand and, in some countries, by transitory factors that have borne down on growth (see Chart 1). External factors have also contributed adversely to developments in the Spanish economy; but in Spain, growth rates have held stable, posting high figures (of around 0.6%-0.7% quarter on quarter) clearly up on those of the euro area as a whole. The greater resilience of the Spanish economy continues to be apparent in the latest economic indicators published, referring both to end-2018 and to 2019 Q1. In this connection, this box evaluates and quantifies the differences in recent developments in the euro area and Spanish economies. Such developments might, in Spain's case, be a reflection of idiosyncratic elements, which would offset the influence of the negative factors affecting both areas, and which would explain the greater slowdown in the euro area.

Very-short-term developments in economic activity can be evaluated with the help of real-time forecasting models¹, such as the dynamic factor models the Banco de España has both for our economy and for that of the euro area, known as Spain-STING and Euro-STING, respectively. These two models are equivalent in methodological terms, although they are designed for real-time forecasting for each particular economy, through the selection of specific conjunctural indicators. These tools have proven very useful for processing the signals obtained from the flow of a

relatively broad set of indicators and for combining them as an overview of the course of GDP growth in the current quarter. With each new release of data on a specific indicator, these models provide for a re-evaluation of the state of the economy, measured through the change in the GDP growth projection in the current quarter.

The comparison of the path of the projections obtained with Spain-STING and Euro-STING allows for a comparative assessment of the impact of the latest information on economic activity in both economies. It should be stressed that, in interpreting the results of these models, greater significance should be given to the changes in the projections over time than to the point estimates themselves; the latter should not generally be interpreted as the best available projection of GDP growth. Indeed, at the Banco de España and among most national and international economic analysts, the usual practice is for the figures provided by the specific models to be complemented, for the formulation of the best projection, by figures from other quantitative tools, and by additional information not from the models.

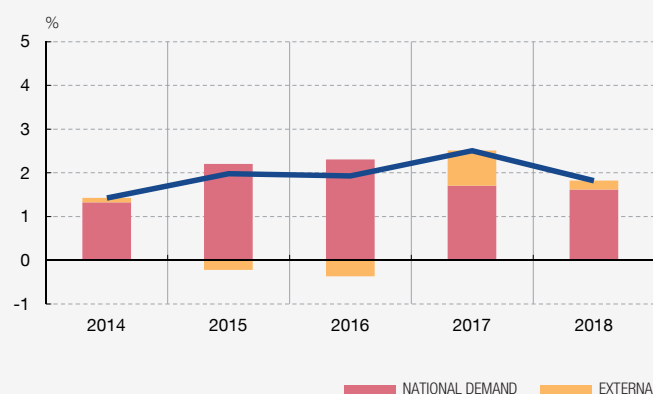
A further aspect to bear in mind is that these models generate forecasts for each of the indicators they incorporate; therefore, the GDP growth forecast will only be revised if the new information differs from that expected by the model. In this way, it is the positive (negative) surprises in the data that positively (negatively) impact the GDP projection. By way of example, positive growth in industrial production will not necessarily translate into an upward revision in the GDP forecast; it will do so only if such growth were higher than that expected by the model.

Table 1 shows the set of indicators published since the start of this year that each of these two models uses. Also given are the date of publication and the differential impact that the incorporation of the indicators has given rise to in the GDP

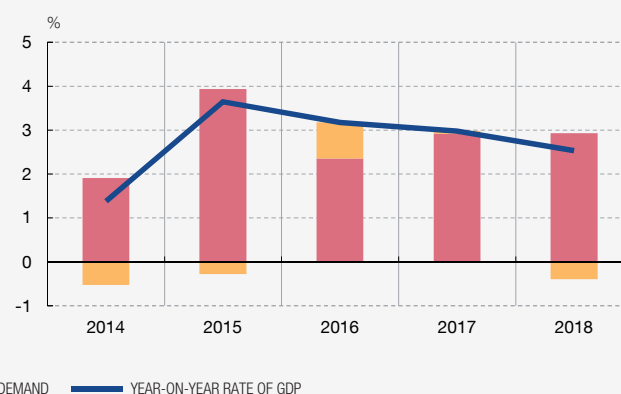
1 See M. Camacho and G. Pérez Quirós (2010), "Introducing the euro-sting: Short-term indicator of euro area growth", *Journal of Applied Econometrics*, 25(4), pp. 663-694, M. Camacho and G. Pérez Quirós (2011), "Spain-Sting: Spain Short-Term Indicator of Growth", *Manchester School*, 79(1), pp. 594-616 and A. Arancibia Pareja, A. Gómez Loscos, M. de Luis López and G. Pérez Quirós (2017), *A short-term forecasting model for the Spanish economy: GDP and its demand components*, Documento Ocasional 1801, Banco de España.

Chart 1
YEAR-ON-YEAR GDP GROWTH AND CONTRIBUTIONS TO GROWTH

1 EURO AREA



2 SPAIN



SOURCE: Eurostat.

forecast in 2019 Q1 for the euro area as a whole and for Spain, respectively. One initial aspect to highlight is that there is no observable uniform pattern regarding the direction in which the new information has affected the growth forecasts for each economy, since the number of downward revisions has been similar to that of upward revisions. However, when the magnitude

of the impacts of the revisions as a whole is quantified, clear differences can be seen between both economies. In this respect, Chart 2 shows directly how the new information received since 1 January has led to a downward revision of the Euro-STING forecasts for quarter-on-quarter GDP growth in the euro area in Q1, while the aggregate effect has been positive in the case of the

Table 1
IMPACT OF THE LATEST INDICATORS ON ECONOMIC DEVELOPMENTS IN SPAIN AND IN THE EURO AREA

Euro-STING				Spain-STING			
Indicator	Release date	Reference period	Impact on GDP	Indicator	Release date	Reference period	Impact on GDP
Composite PMI	04/01/2019	December	=	Social Security registrations	03/01/2019	December	+
Retail sales	07/01/2019	November	+	Electricity consumption in industry	04/01/2019	December	-
ESI	08/01/2019	December	=	Composite PMI	04/01/2019	December	-
Industrial production	14/01/2019	November	-	ESI excluding consumers	08/01/2019	December	-
Employment (revision)	14/01/2019	2018 Q3	=	Non-energy Industrial Production Index	11/01/2019	November	-
Final GDP	14/01/2019	2018 Q3	=	Construction materials Industrial Production Index	11/01/2019	November	=
Exports	15/01/2019	November	-	Sales of large firms	15/01/2019	November	-
New industrial orders	22/01/2019	November	+	Real imports (goods)	22/01/2019	November	=
Composite PMI flash estimate	24/01/2019	January	+	Real exports (goods)	22/01/2019	November	=
ESI	30/01/2019	January	+	ESI excluding consumers	30/01/2019	January	-
Preliminary GDP flash estimate	31/01/2019	2018 Q4	=	Credit	31/01/2019	December	-
Retail sales	05/02/2019	December	-	GDP flash estimate 2018 Q4	31/01/2019	2018 Q4	+
Composite PMI	05/02/2019	January	=	Electricity consumption in industry	01/02/2019	January	+
Industrial production	13/02/2019	December	-	Social Security registrations	04/02/2019	January	-
GDP flash estimate	14/02/2019	2018 Q4	-	Composite PMI	05/02/2019	January	+
Employment	14/02/2019	2018 Q4	+	Non-energy Industrial Production Index	07/02/2019	December	-
Exports	15/02/2019	December	=	Construction materials Industrial Production Index	07/02/2019	December	+
Composite PMI flash estimates	21/02/2019	February	+	Sales of large firms	11/02/2019	December	+
New industrial orders	22/02/2019	December	-	Real imports (goods)	21/02/2019	December	=
ESI	27/02/2019	February	+	Real exports (goods)	21/02/2019	December	=
Composite PMI	05/03/2019	February	=	ESI excluding consumers	27/02/2019	February	=
Retail sales	05/03/2019	January	+	Credit	28/02/2019	January	+
GDP components	07/03/2019	2018 Q4	+	Electricity consumption in industry	01/03/2019	February	-
Employment (revision)	07/03/2019	2018 Q4	=	Social Security registrations	04/03/2019	February	-
Industrial production	13/03/2019	December	+	Composite PMI	05/03/2019	February	=
				Non-energy Industrial Production Index	08/03/2019	January	+
				Construction materials Industrial Production Index	08/03/2019	January	=
				Sales of large firms	12/03/2019	January	+

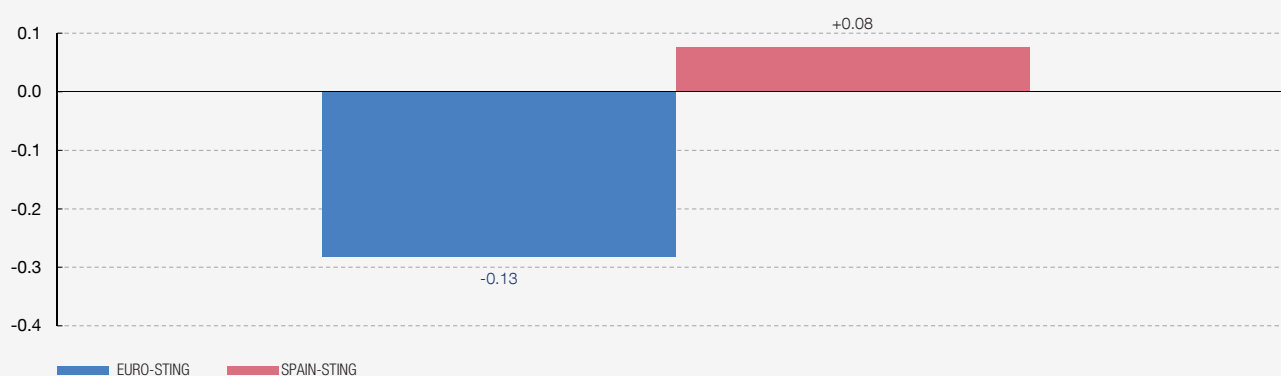
SOURCE: Banco de España.

Spanish economy. In particular, from 1 January to 13 March, the GDP growth projection has fallen by approximately 0.1 pp for the euro area, while it has been revised upwards by 0.1 pp in Spain's case.

In conclusion, the set of conjunctural indicators included in the models and published in recent months has affected the growth forecast for activity in Spain compared with that for the euro area in a differentiated fashion. The divergence between both areas

might be due to the greater impact of idiosyncratic elements in the Spanish economy exerting a positive effect on short-term activity. In any event, it should be qualified that the statistical information available at the cut-off date for this report for 2019 Q1 refers almost exclusively to the first half of the quarter, and to a limited set of indicators. As a result, it cannot be ruled out that elements common to the rest of the euro area may be feeding through, or may ultimately do so with greater intensity, if they persist over time, to the Spanish economy.

Chart 2
FORECAST FOR THE QUARTER-ON-QUARTER GDP RATE IN 2019 Q1. CHANGE FROM 1 JANUARY TO 13 MARCH 2019



SOURCE: Banco de España.

2 INTERNATIONAL FINANCIAL MARKETS

Recovery of financial asset prices in international markets, against a backdrop of more accommodative monetary policies

International financial markets have performed very favourably since the beginning of the year, in contrast with the turmoil experienced at the end of 2018. Thus, in both advanced and emerging economies the stock market indices started 2019 with notable increases, against a background of widespread drops in volatility and greater appetite for risk assets (see Chart 2).

These market dynamics were conditioned by the change in the global monetary policy stance and by greater optimism regarding the possibility of a trade agreement between the United States and China. The measures implemented by the Chinese authorities to counteract the slowdown of the economy and certain positive surprises in US corporate earnings also contributed to this market recovery. These factors weighed more on investor sentiment than the recent downward revision of projected world growth, which was particularly pronounced in the euro area.

In the United States, the Federal Reserve raised its benchmark interest rate at its December meeting, but its communication policy later adopted a clearly accommodative stance. This change in trend was confirmed following the monetary policy meeting of January in which the Fed stated that it would be “patient” with regard to future interest rate adjustments, surprising the market by opening the door to a possible slowing in the pace of its balance sheet reduction.

In the euro area, the ECB also reinforced the accommodative stance of its monetary policy. At its March meeting, the ECB indicated (see Chapter 3.2) that it expects its policy interest rates to remain at the current levels at least until the end of 2019. This is a longer term than stated previously (at least through the summer of 2019). The Governing Council of the ECB also announced a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) with the aim of maintaining favourable financing conditions and a fluid transmission of monetary policy.

These monetary policy decisions have substantially impacted market expectations about future interest rate developments. Thus, US markets do not currently anticipate any rise in the policy interest rates during 2019 and even consider the possibility of a fall in 2020. Meanwhile, market expectations about the date of the first rise in the euro area benchmark interest rates were delayed until October 2020 (see Box 4). These changes regarding the future path of interest rates have pushed long-term sovereign bond yields downward (especially in the euro area) and have helped drive risk asset valuations through the discount rate.

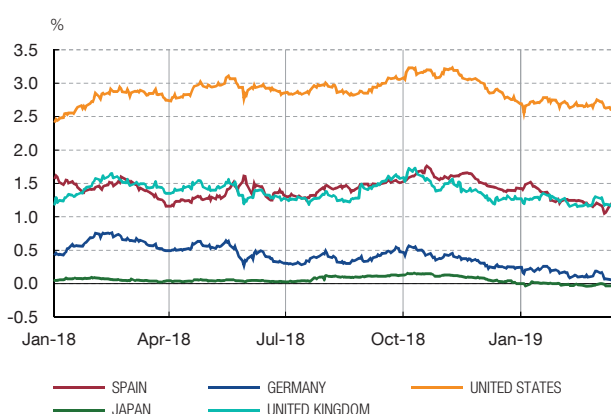
Under this scenario, risk premia have trended downwards. Since the beginning of the year, stock market, term or credit risk compensation has fallen across the board. In fixed income, the compression of sovereign spreads in emerging economies stands out, while the fall in corporate debt risk premia in advanced economies was not sufficient to offset the increases recorded at end-2018.

The year started with stock market gains, but performance in Spain was relatively worse, as it was weighed down by the results of some financial institutions. Sovereign bond yields also decreased, owing to expectations of changes in the monetary policy stance.

1 STOCK EXCHANGE INDICES



2 10-YEAR GOVERNMENT DEBT YIELDS



SOURCE: Datastream.



There were no major fluctuations in foreign exchange markets in the early months of 2019. The appreciation of the pound sterling and the depreciation of the Japanese yen are noteworthy. As in the last few months, the sterling pound exchange rate in the most recent period continued to be marked by swings in market expectations about how and when the United Kingdom will exit the European Union. The recent depreciation of the yen, a currency traditionally used as a safe-haven asset and in carry trade transactions, should be put into perspective considering the strong appreciation recorded at the end of 2018, against a background of strong risk-aversion in the markets. Finally, the euro exchange rate has shown a slight trend towards depreciation, but has not been significantly affected by monetary policy announcements.

Despite favourable market performance since the beginning of the year, important downside risks persist. In particular, the rebound experienced by stock market prices in recent months has once again driven valuations in this market to historically very demanding levels, especially in certain geographical areas. Also, in a context where credit risk premia remain relatively contained, while public and private indebtedness in certain regions remain at very high levels, a stronger or persistent slowing of global growth could give rise to a sharp readjustment of valuations, with potentially highly disruptive effects both for financial markets and for the macroeconomic environment.

3 EXTERNAL ENVIRONMENT OF THE SPANISH ECONOMY

3.1 The external setting of the euro area

Global activity and trade continue to slow, though with cross-regional differences

In 2018 Q4, global activity continued on its slowing path. But there were cross-regional differences. Growth was more robust in the United States and emerging Asia than in other regions, although both the US and the Chinese economies posted a slowdown. Global GDP thus grew 3.7% in 2018 as a whole, 0.1 pp down on 2017 and below expectations at the start of the year. The high-frequency indicators point to the continuation of the slowdown in the global economy at the onset of 2019 (see Chart 3.1).

Global trade contracted in Q4 by 0.9% quarter-on-quarter (q-o-q), after growing by 1.3% q-o-q in the previous quarter. The contraction was especially sharp in the Asian economies, once the anticipation effect prior to the entry into force in September of higher US tariffs on Chinese products waned (see Chart 3.2). Further, sluggish Chinese domestic demand also contributed to the fall in trade. The leading indicators of world trade, such as export orders, augur the continued weakness of trade in goods and services in 2019 Q1.

On the commodities markets, Brent oil prices have risen by over 17% since mid-December to their current level of around \$67. This rise has been essentially due to agreed production cuts by OPEC and other producers, and to the impact of US sanctions on Venezuela and Iran on supply. Metal prices have also risen.

Activity in the advanced economies prompted a downward surprise and US growth slowed, leading the Federal Reserve to adopt a cautious stance

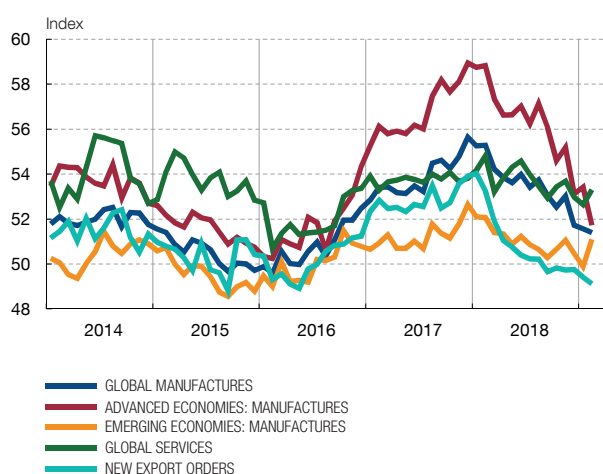
US GDP growth in Q4 was 2.6% in annualised quarterly terms, following a rate of 3.4% in Q3. This was due to the slowdown in private consumption, and despite investment rising somewhat (see Chart 4.1). In the United Kingdom, GDP growth fell to 0.2% q-o-q against the background of high uncertainty surrounding Brexit, reflected in a heavy decline in investment. In Japan, GDP grew 0.3% q-o-q, after a decline of 0.7% in Q3, although the external sector maintained a negative contribution. Inflation rates continued on a declining trend (see Chart 4.2), reflecting the course of the energy component. Core inflation rates, meantime, held stable despite wage growth and the favourable juncture labour markets are at (see Chart 4.3). Given the doubts over global growth, the tensions on financial markets and scant inflationary pressures, central banks have adopted a more cautious stance (see Chart 4.4). The Federal Reserve departed from its monetary policy normalisation path, adopting a stance that was more neutral and dependent on economic developments. It also signalled that its balance sheet reduction would conclude in the second half of 2019. The Bank of Japan revised its inflation outlook downwards and kept its monetary policy measures unchanged. The Bank of England, for its part, cut its GDP growth forecast and stands ready to react to Brexit-related events. In this connection, a currency swap arrangement has been activated between the Bank of England and the ECB for the lending of euro and pound sterling to banks, in support of market workings.

Emerging financial markets trended favourably against a backdrop of more accommodative monetary policies, following the Federal Reserve's action and China's stimulus policies

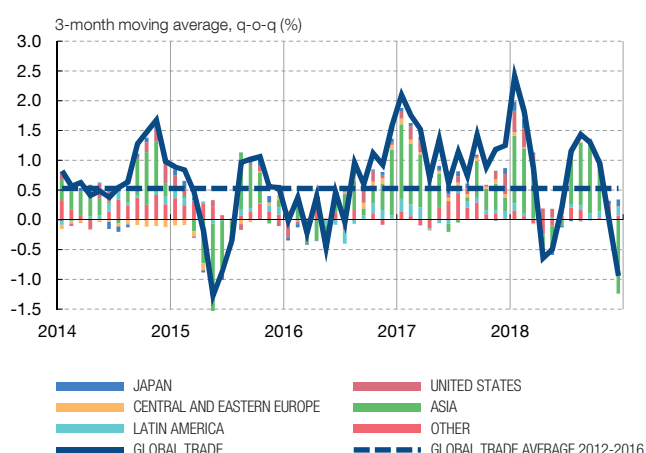
In the emerging economies, the financial markets behaved favourably. As described in section 2, this was due to the more accommodative monetary policy outlook in the

The high-frequency indicators point to the continuation of the slowdown in the global economy at the start of 2019. The contraction in global trade was particularly sharp in the Asian economies, once the anticipation effect prior to the entry into force in September of higher US tariffs on Chinese products waned.

1 GLOBAL PMI



2 GLOBAL TRADE GROWTH AND CONTRIBUTIONS



SOURCES: CPB, Markit and own calculations.



United States, the new stimulus measures in China and greater optimism over a possible China/US trade deal (see Charts 5.1 to 5.3). Stock market indices trended positively (especially in Asia, led by China), exchange rates generally held fairly stable, there were net capital inflows and fixed-income issuances rose in January and February. Notable exceptions were Argentina and Turkey. In the former, the markets were affected by high inflation figures and the central bank's regulatory changes. In the latter, the government's new interventionist measures were a factor. Mexico was also a case in point. The peso depreciated following the downgrading of the state-owned oil company PEMEX to below investment grade.

Activity in the emerging economies was also generally less dynamic. Growth in China eased in Q4 from 6.5% to 6.4% year-on-year. The result was the outcome of the escalating trade war with the United States, and of the tightening of the financial deleveraging policies set in place in 2018 (see Chart 6.1). But faced with the risks of a sharper slowdown, the authorities have responded with fiscal, monetary and financial stimuli. In Latin America, the National Accounts data for Q4 showed the low growth in the two biggest economies, Brazil and Mexico, and the continuing recession in Argentina. The emerging economies' monetary policies have generally held unchanged, in the face of the Federal Reserve's more accommodative stance, and of the favourable behaviour of inflation (see Chart 4.2) and of the financial markets.

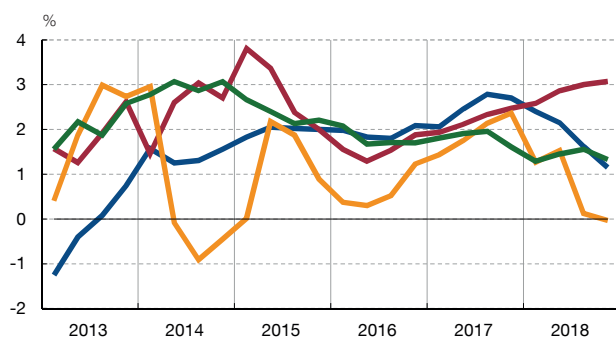
3.2 The euro area and the European Central Bank's monetary policy

The sluggishness of euro area economic activity in late 2018 is a reflection of external and other domestic factors affecting specific countries and sectors

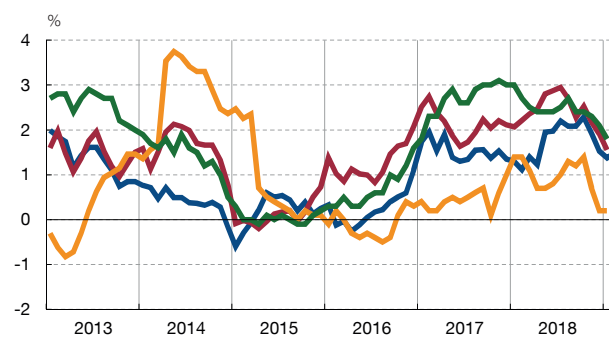
In the euro area, the modest pace of economic activity continued to surprise. In Q4, GDP growth was 0.2% q-o-q, similar to the previous quarter and below expectations (see Chart 7.1). Country by country, the low figure was a reflection of almost zero GDP growth in Germany and a contraction in activity in Italy for the second quarter running (see Chart 7.2).

Developments in the main advanced economies were somewhat uneven. Inflation rates remained on a downward trend despite the favourable juncture labour markets are at. Central banks have adopted a more cautious stance.

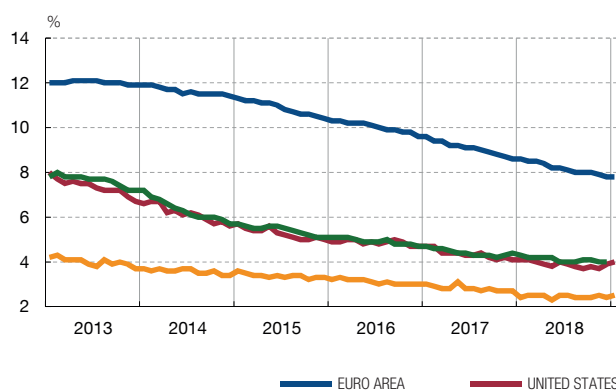
1 GROSS DOMESTIC PRODUCT
Year-on-year rate



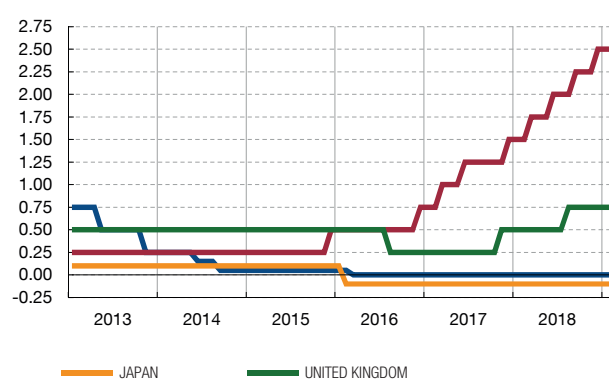
2 INFLATION
Year-on-year rate



3 UNEMPLOYMENT RATE (a)



4 POLICY INTEREST RATES



SOURCES: IFS and Banco de España.

a Percentage of labour force.



The year-on-year increase stood at 1.2% in Q4, the result of an easing in the contribution of domestic demand and, above all, of net external demand. Private consumption moderated, against a background of lower employment growth.

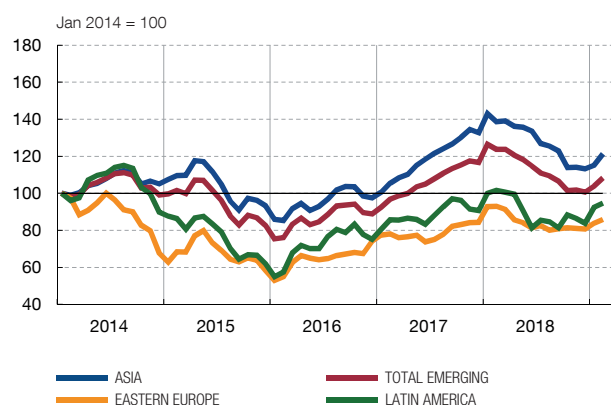
The slowdown in activity reflects a combination of external and domestic factors, in a setting of high uncertainty. As Box 2 explains, euro area external demand has dipped to a greater extent than world trade. Moreover, the uncertainty from the external environment is notably affecting business confidence and investment. There are also domestic factors affecting specific countries and sectors. These factors are exerting a more protracted effect than foreseen, especially those relating to the car industry.

Euro area GDP growth forecasts have been revised notably downwards, especially for 2019

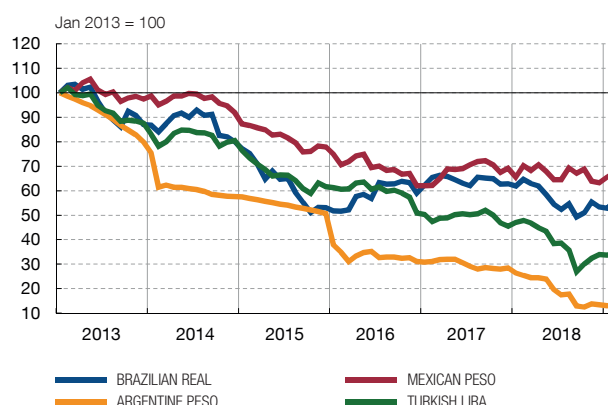
The latest and mainly qualitative indicators tend to see this scenario of weakness running throughout the first half of 2019. Business and consumer confidence and export expectations have tended to become bleaker. In manufacturing the indicators point to a possible contraction in Q1. Few quantitative indicators are available. But they indicate a

The emerging economies' financial markets performed favourably. This was reflected in stock markets, in currency appreciations and in a reduction in sovereign yields. On the commodities markets Brent oil prices have increased by more than 17% since mid-December.

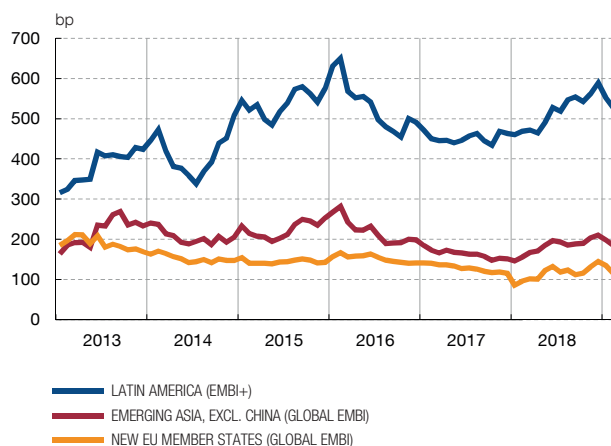
1 EMERGING STOCK INDICES



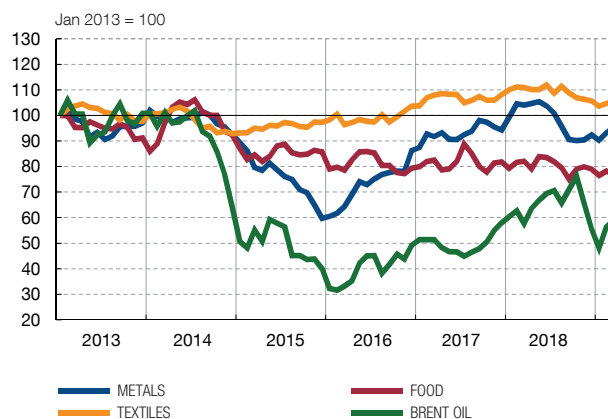
2 EXCHANGE RATE AGAINST THE DOLLAR (a)



3 INTEREST RATE SPREADS AGAINST THE DOLLAR (b)



4 COMMODITIES



SOURCES: IFS and Banco de España.

a A decrease in the index denotes a depreciation of the currency against the dollar.

b JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary, Poland, Romania and, from July 2013, Croatia.

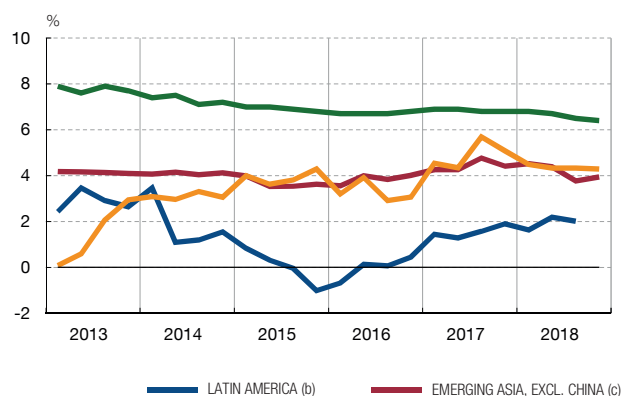
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slight improvement, especially in the IPI, following the strong adjustment it underwent in late 2018. Credit to firms, by contrast, has begun to show signs of slowing. The unemployment rate held stable at 7.8% in January.

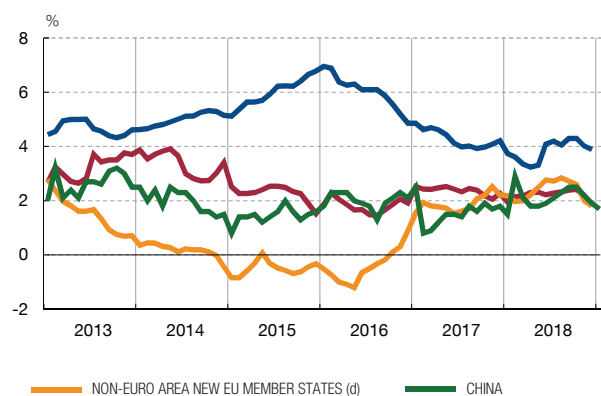
Against this backdrop, the growth outlook for the euro area has been revised downwards both by private analysts and official institutions, especially for 2019. The March ECB forecasting exercise subtracted 0.6 pp from GDP growth for this year, placing it at 1.1%. That is a reflection of the worse-than-expected behaviour in late 2018 and early 2019. These forecasts mean that as the transitory factors that are affecting activity peter out, GDP will resume higher growth rates (see Table 2). Underpinning these will be favourable financial conditions, the increase in employment and wages, lower energy prices and a slightly expansionary fiscal policy. But this scenario is surrounded by downside

Activity in the emerging economies has generally been less dynamic. Inflation, measured by the rate of change of consumer prices, has continued to decline.

1 GROSS DOMESTIC PRODUCT (a)
Year-on-year rate



2 CONSUMER PRICES (a)
Year-on-year rate



SOURCES: IFS and Banco de España.

a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.

b Brazil, Chile, Colombia, Mexico and Peru.

c Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.

d Poland, Hungary, Czech Republic, Bulgaria, Romania and, from July 2013, Croatia.

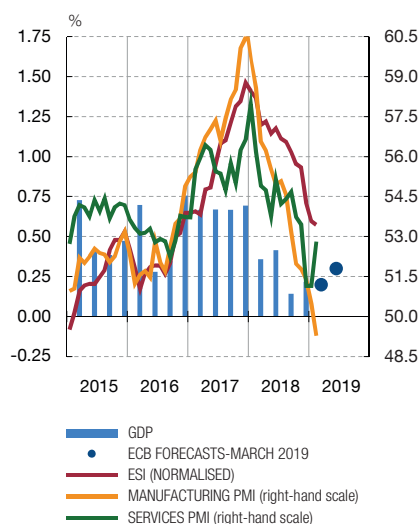
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EURO AREA ECONOMIC EXPANSION LOSES MOMENTUM

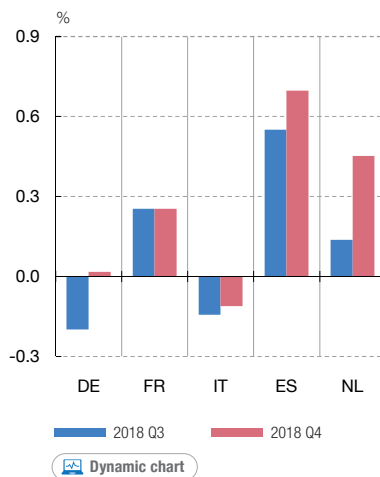
CHART 7

The weakness of euro area economic activity continued to surprise in late 2018, and this scenario appears to be running into the first half of 2019. The low growth in Q4 reflected the practically zero GDP growth in Germany and the contraction in the Italian economy for the second consecutive quarter.

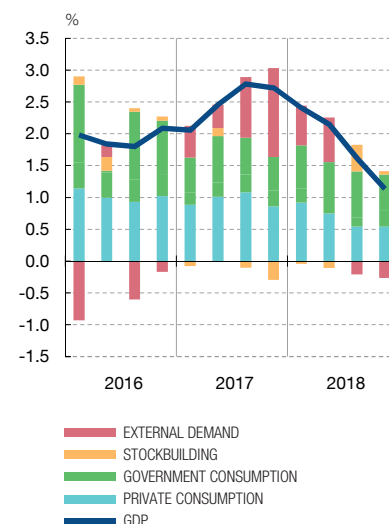
1 QUARTER-ON-QUARTER GDP GROWTH
AND SURVEY-BASED INDICATORS



2 GDP BY COUNTRY
Quarter-on-quarter rate



3 YEAR-ON-YEAR GDP GROWTH
AND CONTRIBUTIONS



SOURCES: Eurostat, European Commission, Markit Economics and ECB.

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	2019		2020		2021	
	GDP	HICP	GDP	HICP	GDP	HICP
European Central Bank (March 2019)	1.1 (-0.6)	1.2 (-0.4)	1.6 (-0.1)	1.5 (-0.2)	1.5 (0.0)	1.6 (-0.2)
European Commission (February 2019)	1.3 (-0.6)	1.4 (-0.4)	1.6 (-0.1)	1.5 (-0.1)	—	—
OECD (March 2019)	1.0 (-0.8)	—	1.2 (-0.4)	—	—	—
International Monetary Fund (January 2019)	1.6 (-0.3)	—	1.7 (0.0)	—	—	—
Consensus Forecast (February 2019)	1.3 (-0.2)	1.4 (-0.1)	1.4 (0.0)	1.5 (0.0)	1.2 (—)	—

SOURCES: ECB, European Commission, Consensus Forecast, IMF and OECD.

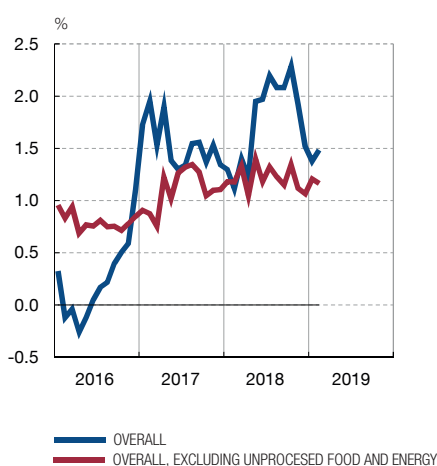
a In brackets is the change relative to the previous forecast (December 2018 for the ECB, November 2018 for the EC and the OECD, October 2018 for the IMF and January 2019 for Consensus Forecast).

EURO AREA INFLATION REMAINS AT MODERATE LEVELS

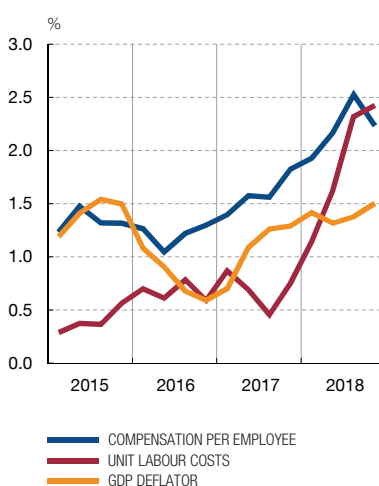
CHART 8

Euro area inflation has fallen to a rate of 1.5%, influenced by oil prices. Core inflation held at around 1%. There are no evident signs of a feed-through of higher labour costs to inflation.

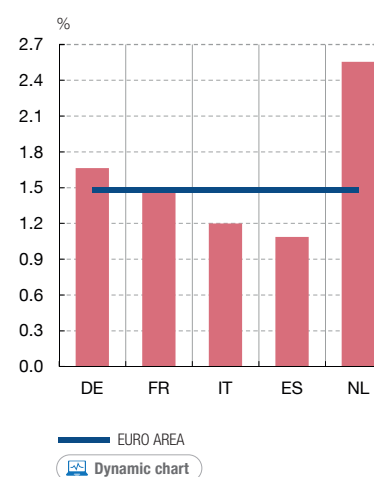
1 HARMONISED INDICES OF CONSUMER PRICES



2 WAGES AND COSTS



3 OVERALL HICP
February 2019



SOURCE: Eurostat.



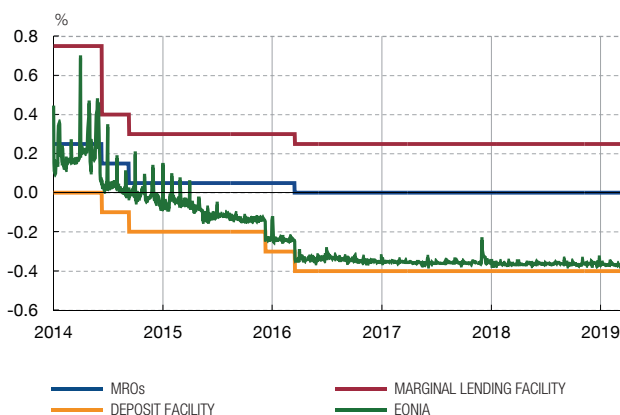
risks: the possibility of a greater-than-expected slowdown in the Chinese economy; a disorderly Brexit; a heightening of protectionist measures in international trade; and, internally, the risk of financial tensions, owing to the economic recession and the fiscal uncertainty in Italy.

The euro area inflationary scenario is also easing both in the short and medium term

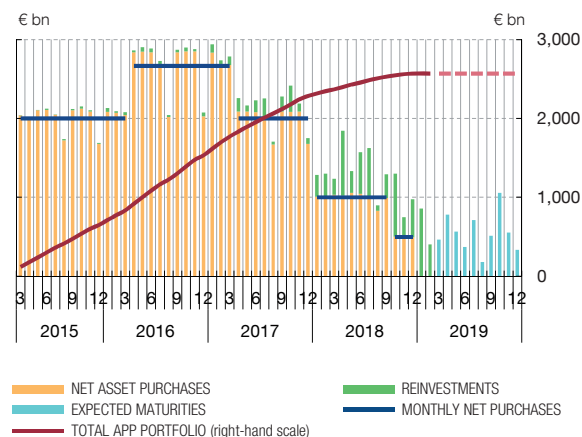
Euro area inflation has declined owing to the effect of the energy component. The year-on-year growth of the harmonised index of consumer prices (HICP) stood at 1.5% in February. Meanwhile, the measures of inflation that exclude the most variable components have held stable at moderate levels of slightly over 1% (see Chart 8), with no signs yet apparent of the pass-through of wage increases to consumer prices.

Monetary policy remains very expansionary following the ECB guidance on the extension of the period over which interest rates will hold at their current levels and on the size of its APP portfolio beyond the first rise in rates.

1 EONIA AND ECB POLICY INTEREST RATES



2 ASSET PURCHASE PROGRAMME



SOURCE: ECB.

The March ECB forecasting exercise revised the headline and core inflation outlook downwards for the next three years. Inflation is expected to continue declining in 2019, as a result of the energy component. Subsequently, it will pick up gradually, on the back of less slackness in the economy, which will sustain wage growth. The ECB specifically expects the inflation rate to stand at 1.2%, 1.5% and 1.6% in 2019, 2020 and 2021, respectively (see Table 3). Core inflation, likewise revised downwards over the entire forecasting horizon, will post respective figures of 1.2 %, 1.4% and 1.6% in 2019, 2020 and 2021.

The macroeconomic imbalances are slowly being corrected

In February the European Commission published the European Semester Winter Package. This comprises reports for the 28 EU countries, including the in-depth assessments of the 13 countries identified in the November 2018 early-warning mechanism. Three of them, namely Cyprus, Greece and Italy, have – according to the terminology used in the exercise – an excessive economic imbalance. The remaining 10 countries – Bulgaria, Germany, Spain, France, Croatia, Ireland, the Netherlands, Portugal, Romania and Sweden – have an economic imbalance. Generally, the Commission considers that the macroeconomic imbalances have continued to be corrected. That said, in some countries there are still vulnerabilities relating to high public and private debt, low profitability and asset quality in the banking sector, and the negative external position.

With the end of net asset purchases, monetary policy retains a highly accommodative stance, strengthened by the Governing Council's decisions in March

Turning to monetary policy, the ECB Governing Council, at its meeting on 7 March, decided on new measures to preserve monetary stimulus. Given the downturn in the euro area growth outlook and the more moderate inflation scenario, the Governing Council adjusted its monetary policy (see Chart 9). First, it extended the period during which policy

rates are expected to remain at their current low levels at least through the end of 2019, and in any case, as long as necessary to ensure the sustained convergence of inflation towards levels close to 2% in the medium term. Market expectations about the future course of policy rates changed along these lines (see Box 4). As regards the Asset Purchase Programme (APP), the ECB decided to continue reinvesting principal payments from maturing securities over a prolonged period, beyond the date of the first rise in rates.

Moreover, the Council introduced a new series of longer-dated refinancing operations, to preserve favourable bank lending conditions. The new series of targeted long-term refinancing operations (TLTRO III) will be launched between September 2019 and March 2021. The frequency will be quarterly, the term of maturity two years and the interest rate will be indexed to that on the main refinancing operations over the life of each operation. Lastly, the Council decided to maintain the full allotment procedure in monetary policy refinancing operations for as long as necessary, and at least until March 2021.

4 THE SPANISH ECONOMY

Financial conditions generally remained loose

Spanish stock markets performed very positively in the year to date and the Ibex-35 gained as much as 8%. This performance is in line with the general favourable developments in international financial markets. The Spanish banking sector performed less positively than the overall index and the aggregate of European banks, partly owing to the publication of results for 2018 which were lower than analysts' expectations.

The cost of financing in the Spanish government debt market fell significantly in the early months of 2019. For instance, Spanish ten-year sovereign bond yields have fallen by approximately 25 bp since the beginning of the year. This reflects the compression of the risk premium relative to Germany and, to a greater degree, the downward adjustment in German ten-year bond yields in response to a more accommodative monetary policy stance.

In recent months, bank credit standards for households and non-financial corporations have remained very loose, although signs that this trend is tailing off are emerging. Average interest rates on new lending have remained low, although they increased somewhat in the final stretch of 2018 (see Chart 10.1). The Bank Lending Survey (BLS) shows that credit standards tightened slightly in 2018 Q4 in the consumer credit and other lending segment, which had not happened since the beginning of 2013 (see Chart 10.2). Furthermore, the banks anticipate that, for the first time since 2012, lending standards will tighten across all loan segments in 2019 Q1.

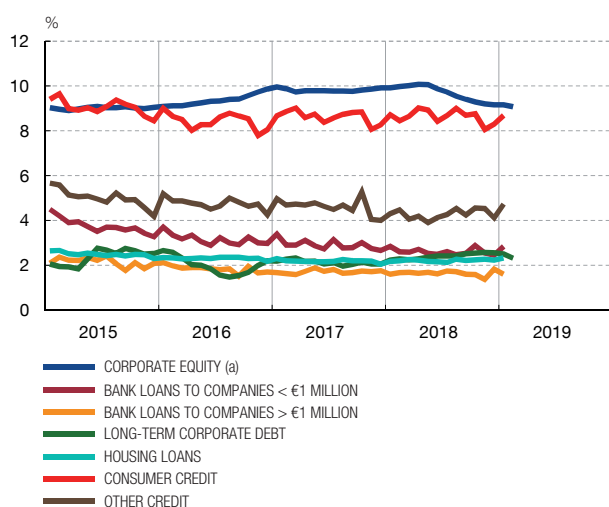
The positive growth rate of the Spanish economy has continued, despite the unfavourable developments in the international environment.

The Spanish economy slowed down over 2018 against a background of a worsening international environment and heightened uncertainty. Specifically, GDP climbed by 2.5% – 0.5 percentage points (pp) less than in 2017 – recording a similar performance to that of employment, against a backdrop of the improved financial situation of the non-financial private sector and favourable financial conditions. The deceleration of GDP was a result of the negative contribution from net external demand (see Chart 11), following its positive contribution during the two previous years. Exports slowed down more sharply than imports owing to the much less buoyant performance of Spain's main export markets, the delayed effect of the 2017 euro appreciation and, possibly, the negative transitory impact of new regulations on vehicle emissions. Domestic demand continued to contribute positively to aggregate growth, at a similar level to the previous year, but it started to flag in 2018 Q4.

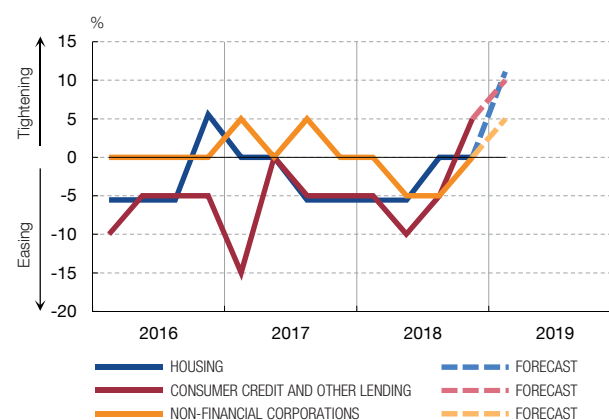
According to the Banco de España's updated projections, GDP continued to post robust growth at the beginning of 2019, despite slowing somewhat. GDP is projected to rise by 0.6%, as compared with 0.7% in 2018 Q4. Although these projections were made against a backdrop of weak global demand, the pick-up in GDP would, however, be in line with the average increase observed in 2018. Thus, it is estimated that GDP growth will continue to be underpinned by national demand in 2019 Q1. Residential and business investment will behave less unfavourably than in the closing months of 2018 and private

Bank credit standards have remained loose. Costs have generally continued to be stable, although the Bank Lending Survey points to a tightening of credit standards for consumer credit and other lending. For the first time since 2012, the banks anticipate a tightening in all segments in the first quarter of 2019.

1 COST OF FINANCING



2 BLS. CHANGES IN CREDITS STANDARDS (b)



SOURCES: Morgan Stanley, Datastream and Banco de España.

a The cost of equity is based on the three-stage Gordon dividend discount model.

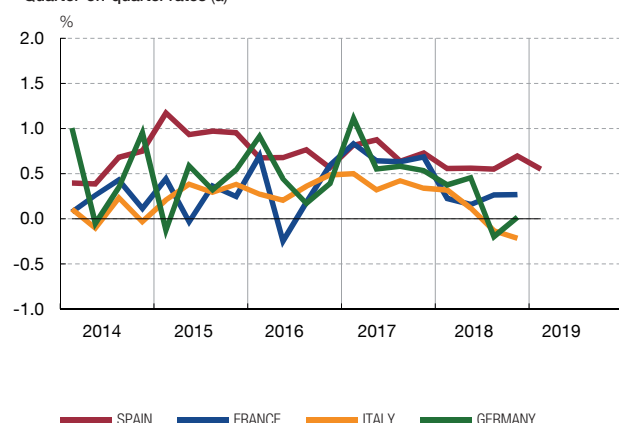
b Bank Lending Survey. Indicator = percentage of banks that have tightened their credit standards or their margins considerably $\times 1$ + percentage of banks that have tightened their credit standards or their margins somewhat $\times 1/2$ - percentage of banks that have eased their credit standards or margins somewhat $\times 1/2$ - percentage of banks that have eased their credit standards or margins considerably $\times 1$.

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THE SPANISH ECONOMY HAS REMAINED ROBUST

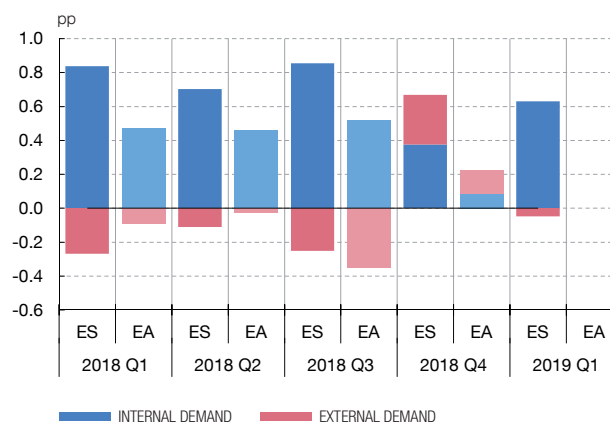
CHART 11

The Spanish economy has shown more buoyancy in the last few quarters than the main European economies.

1 GDP GROWTH.
Quarter-on-quarter rates (a)

[Dynamic chart](#)

2 CONTRIBUTIONS TO REAL GDP QUARTERLY GROWTH (a)



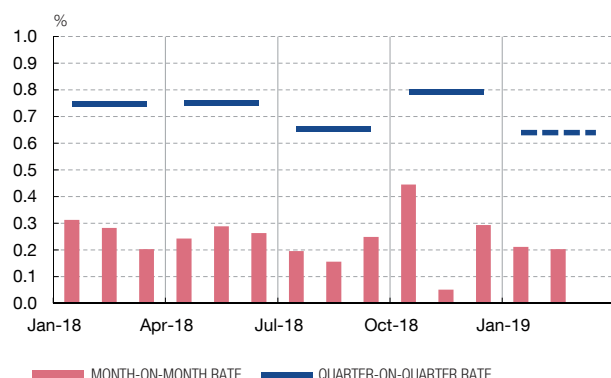
SOURCES: INE, ECB and Banco de España.

a Banco de España projections for 2019 Q1.

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As a result of ongoing highly buoyant job creation, there is a protracted downward trend in the unemployment rate.

1 SOCIAL SECURITY REGISTRATIONS



2 UNEMPLOYMENT RATE (LFS)



SOURCES: INE, Ministerio de Trabajo, Migraciones y Seguridad Social and Banco de España.



consumption will continue to increase, whereas the contribution of external demand, for which only very limited information is yet available, would be slightly negative.

Employment will slow more sharply than activity in Q1. Employment will grow by 0.4% in the January-March period, 0.2 pp down on the previous three-month period, based on available information on social security registrations, which points to this variable slowing down in the first few months of the year (see Chart 12).

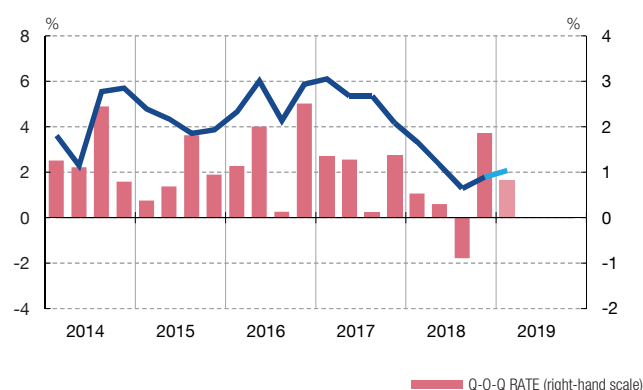
The loss of momentum in exports is sharper in goods

The slightly negative contribution of the external sector in Q1 reflects similar growth of exports and imports. Nevertheless, in the opening months of the year transactions with the rest of the world showed a slowing profile (see Chart 13), which was slightly more pronounced in exports. The behaviour of sales abroad reflects the worsening outlook for world markets, including the euro area, Spain's main export market. Accordingly, the indicators of the outlook for foreign orders were recently seen to be contractionary. However, the depreciation of the euro against the major currencies since the beginning of this year could contribute to supporting sales abroad, given that its appreciation since 2017 would be reversed, at least in part. The sensitivity of Spain's exports to price competitiveness is relatively high, owing in part to their composition, since low and medium-low technology-intensive products have a higher relative weight than in the main euro area countries. Import performance is estimated to be consistent with final demand, thus a portion of the deceleration of purchases from the rest of the world is linked to export performance, given the high import content of exports in certain industries, such as the automotive industry.

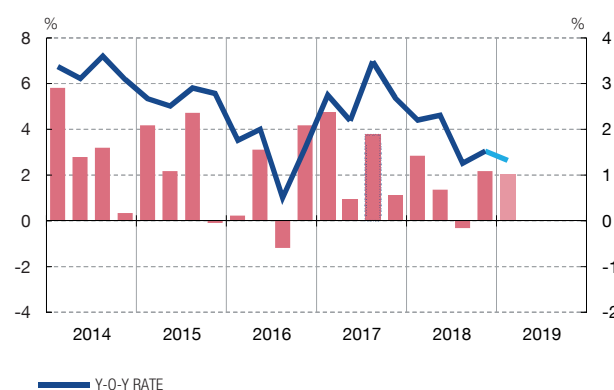
The loss of momentum of goods exports was widespread in terms of products and markets. According to the most recent customs data, real goods exports declined across the board, except for exports of capital goods, in particular consumer durables, including vehicles and energy products. By geographical area, the decrease was more pronounced in non-EU sales, against a backdrop of a significant appreciation of the euro, particularly against certain currencies of emerging countries. Real imports also decreased across the

The negative contribution of net external demand to year-on-year GDP growth eased in 2019 Q1.

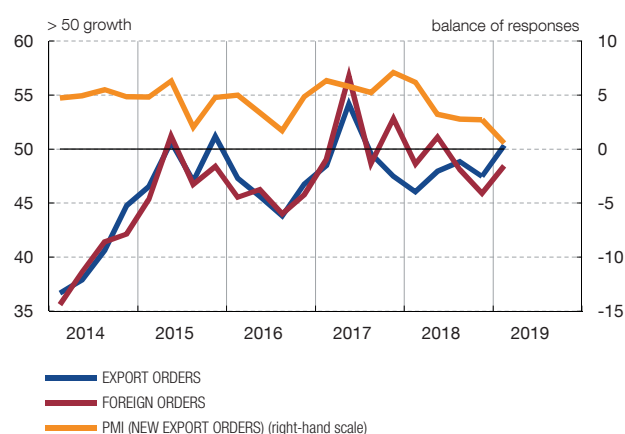
1 GOODS AND SERVICES EXPORTS (a)



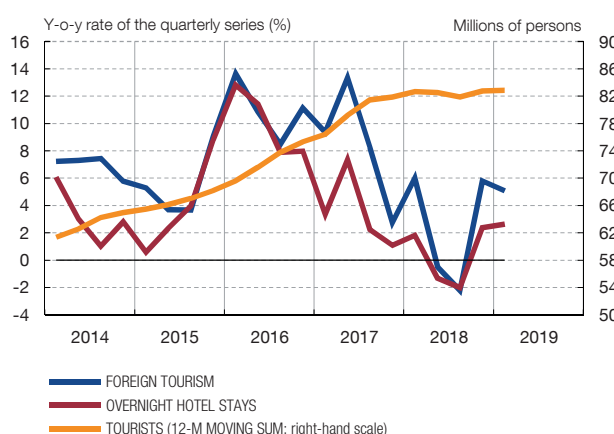
2 GOODS AND SERVICES IMPORTS(a)



3 CONFIDENCE INDICATORS



4 FOREIGN TOURISM INDICATORS



SOURCES: INE, Ministerio de Industria Comercio y Turismo, European Commission, Markit and Banco de España.

a QNA data at constant prices. Seasonally-adjusted series. Banco de España projections for 2019 Q1.

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board in terms of products, particularly non-energy intermediate goods, except for non-food and non-durable consumer goods, and especially energy products.

As for exports of services, the main indicators of foreign tourism have picked up considerably in recent months. Total tourist spending rebounded owing to the favourable developments in overnight stays in hotels and inflows of foreign tourists. The increase in foreign tourist numbers was quite broad-based across tourism-generating markets, including Britain, despite the ongoing weak performance of tourists from Germany.

The external downturn largely explains the poorer performance of industrial activity compared with other sectors

By sector, noteworthy was the contraction of industrial activity, in common with the advanced countries, which was amply offset by the buoyancy of services and construction. The fall in industrial activity in the second half of 2018 could continue in the initial months of 2019, according to certain available indicators, such as the manufacturing

PMI, although the available information is still very limited. The performance of industry is highly influenced by the unfavourable developments in the external environment. However, available short-term economic information shows that the growth rates of services and construction could remain significant and similar to those recorded in previous quarters. Employment, according to data on social security registrations, shows a very similar performance at large sectors to that estimated for industrial activity.

The Spanish economy is showing more resilience than the euro area on account of internal demand, although there are risks to the continuation of the strong rate of consumption

The Spanish economy is showing greater resilience to the global slowdown than the main euro area countries. In this regard, estimated quarter-on-quarter growth of 0.6% for 2019 Q1 contrasts with the available projections of around 0.2% for the euro area as a whole. The higher rate of increase of the Spanish economy is mainly linked to buoyant private domestic demand, as occurred in 2018.

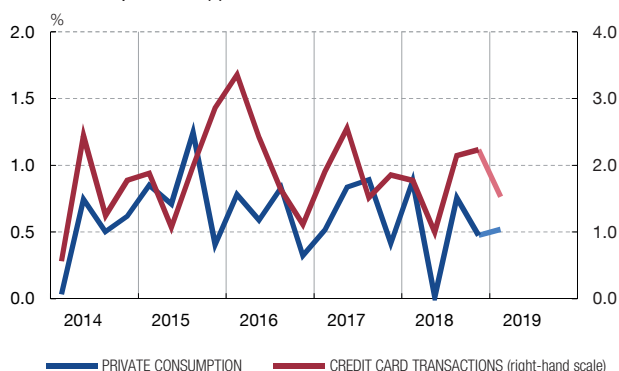
Among the main demand components, private consumption is estimated to remain buoyant in the first quarter. Based on available information, this component is estimated to continue growing at a similar rate to that observed in the October-December period, of around 0.5% (see Chart 14). Although spending indicators generally performed robustly, it should be underlined that in recent quarters consumer confidence has been showing a sustained deterioration. Job creation and favourable financial conditions continue to act as a support for the buoyancy of consumption. As for product type, recent developments in consumption seem to be sustained to a greater degree by spending on durable and semi-durable goods, whereas spending on durable consumer goods could be slowing down according to the available partial indicators. This is in line with the estimated gradual petering out of the reabsorption of pent-up demand for this type of goods which was the driver behind the marked buoyancy of consumption during the early stages of the recovery.

The growth of consumption is coupled with a lower saving rate and high growth of credit earmarked for financing this type of purchases. This poses risks to the continuity of the strength observed in private consumption. The saving rate, on the latest available data, once again posted a record low, in a setting where households increased their financing needs. The volume of new consumer loans continued to rise significantly. That said, their rate of increase eased in the final stretch of 2018 as, according to the BLS, new loan applications came to a halt and lending conditions tightened slightly. This would signal a continuation of these developments in Q1, as anticipated by the banks. By contrast, households' financial wealth is estimated to have strengthened further in 2018 Q4 with the continued contraction of debt and debt burden ratios relative to gross disposable income. The buoyancy of income and the recovery of wealth would have been maintained, underpinned by higher house prices, which offset the decline in the financial component associated with the fall in stock prices.

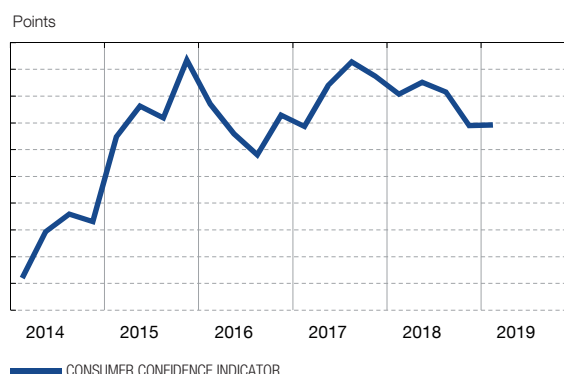
Residential investment continues to perform favourably. Following the decline of the previous three months, residential investment is expected to recover in Q1, as suggested by the expectations for the construction sector and its activity indicators, and the relative buoyancy of the real estate market, both as regards prices and housing sales and purchases. However, the most recent data on loans for house purchase show some slowdown in activity, which, according to the BLS, may reflect weaker demand.

Private consumption will continue to show relatively high growth rates in 2019 Q1, although the low saving rate and slowdown of credit pose risks to the continuation of this strength in the medium term.

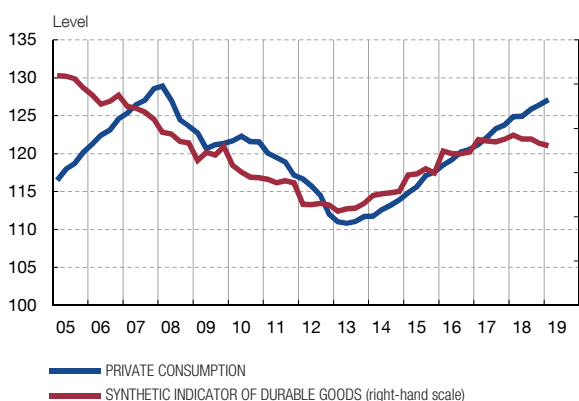
1 PRIVATE CONSUMPTION AND CREDIT CARD TRANSACTIONS
Quarter-on-quarter rate (a)



2 CONSUMER CONFIDENCE



3 DURABLE CONSUMPTION



4 NEW CONSUMER LOANS
Year-on-year rates (b)



SOURCES: European Commission, INE, Google Trends and Banco de España.

a Banco de España projections for 2019 Q1.

b Calculations based on cumulative three-month flow.

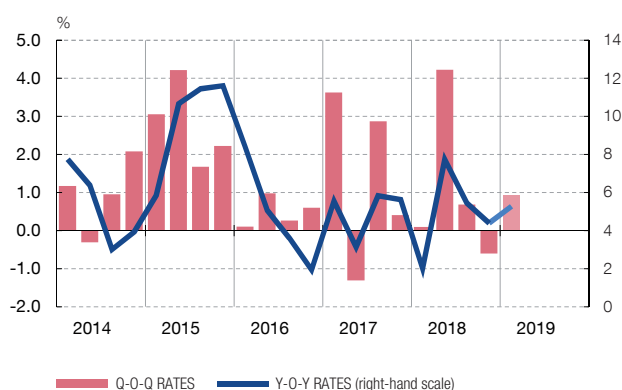
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Real estate market activity and price trends again show a high degree of geographical heterogeneity. Although the real estate market has picked up virtually throughout the whole of Spain, there are notable regional differences, both in terms of transactions and prices. The most positive developments were observed in large cities and on the coast, where activity is more buoyant, foreign demand stronger and there is a higher density of population.

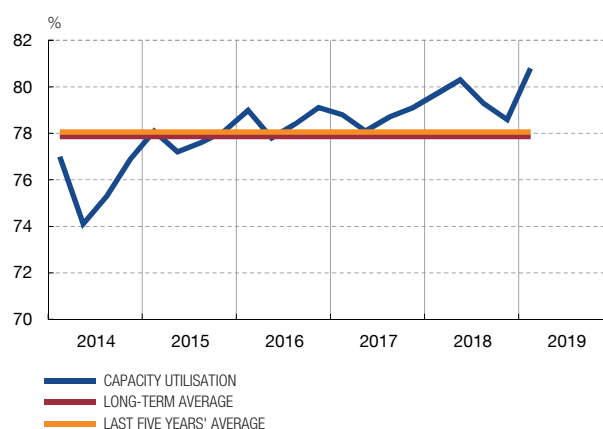
The growth profile of investment in capital goods and intangibles is expected to recover in Q1, following the poor figures of 2018 Q4 (see Chart 15). This highly volatile national demand component performed unfavourably, against a background of heightened external and internal uncertainty, in particular, about the outlook for foreign trade and economic policy. That said, the available information points to improved investment in capital goods and intangibles in 2019 Q1, despite the continued worsening of uncertainty indicators. The generally favourable information available is in keeping with the continuation of the broader economic upturn, the positive earnings expectations, the need for equipment renewal in a context of high capacity utilisation, and the ongoing accommodative financial conditions. The financial position of non-financial corporations continued to strengthen in

This domestic demand component is expected to recover in Q1, in a setting of high capacity utilisation and ongoing accommodative financial conditions. However, the recent deterioration of uncertainty indicators is a risk factor.

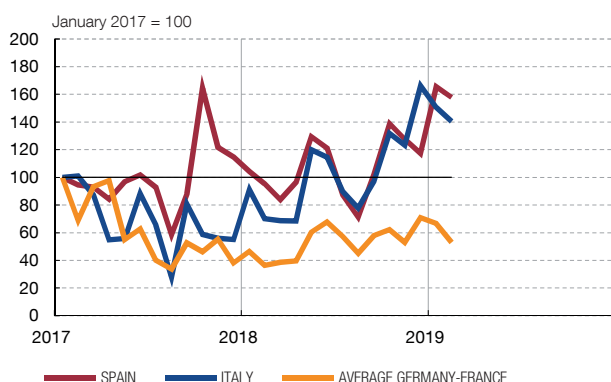
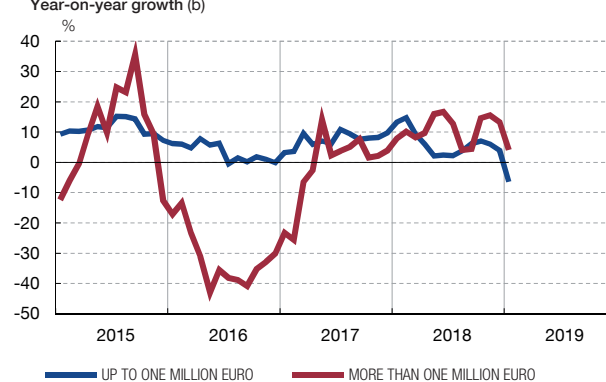
1 INVESTMENT IN CAPITAL GOODS, INTANGIBLES AND OTHER (a)



2 CAPACITY UTILISATION IN THE INDUSTRY



3 ECONOMIC POLICY UNCERTAINTY INDEX

4 NEW LOANS FOR CORPORATIONS
Year-on-year growth (b)

SOURCES: European Commission, www.policyuncertainty.com, INE and Banco de España.

a Includes machinery, capital goods, weapons systems, cultivated biological resources and intellectual property products. Banco de España projections for 2019 Q1.
b Calculations based on cumulative three-month flow.

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2018 Q4. In this period, the financial burden continued to decrease, albeit slightly, and the indebtedness ratio remained at similar levels to those of the previous quarter.

Despite being generally positive, external financing of non-financial corporations has slowed in recent months. Noteworthy was the loss of momentum of bank lending, one of the components of this financing. According to the BLS, this would essentially be explained by demand factors.

The course of fiscal policy remains unclear

In recent months, a number of fiscal policy measures were adopted, affecting both revenue and expenditure. These measures were approved under the Spanish Parliament's rejection of the State Budget submitted by the Government in January. That entailed further extending the 2018 budget which had come into force at the beginning of the year. Although most of the budget items remain set at the nominal

levels of the previous year, the same does not apply to the items affected by the royal decrees approved by Parliament,² insofar as they can be financed through budget appropriations.³

Against this backdrop, the fiscal policy stance is expected to be expansionary, according to the Banco de España's general government deficit estimates, excluding cyclical factors. Although there is a great deal of uncertainty surrounding the quantification and degree of implementation of the different fiscal policy measures during the year, these may provide some stimulus for the economy in the short term. According to the latest information, tax revenues remain robust, as in recent quarters, and are expected to partly offset the rise in government spending and enable the deficit to remain on a correction path in the first part of the year. However, the expansionary nature of fiscal policy would also further deteriorate the underlying state of public finances, which makes the economy vulnerable, in the aforementioned context of global uncertainty, and reduces the leeway for fiscal policy in the short and medium term.

In this scenario, the European authorities will be assessing whether Spanish general government has overcome the “excessive deficit” situation. In the first half of 2019, the EU Council is expected to confirm an exit scenario from the Excessive Deficit Procedure applied to the Spanish general government since 2009, as part of the “corrective arm” of the EU's Stability and Growth Pact. To this end, the authorities shall assess whether the budget deficit held steadily below 3% of GDP in 2018. Although the latest available data seem to confirm that the deficit in 2018 was below the 3% reference, the estimate for the 2019 budget balance is less certain, since there are no guiding principles in place.

Low dynamism of prices in the absence of external inflationary pressures and wage rises

Inflation, as measured by the Harmonised Index of Consumer Prices (HICP), slowed early in the year to 1.1% in February, from 1.8% in 2018 Q4 (see Chart 16). This decline was across the board, affecting not only the more stable components of the index, but also the more volatile ones, of energy and food (see Chart 16). Core inflation, as measured by the HICP excluding energy and food, stood at 0.7% in February, in year-on-year terms, in a setting in which the output gap, which measures the degree of capacity utilisation, is expected to have widened. In terms of components, services slowed significantly, to 1.2%, compared with 1.6% in 2018 Q4, while the prices of non-energy industrial goods held virtually flat as in previous quarters.

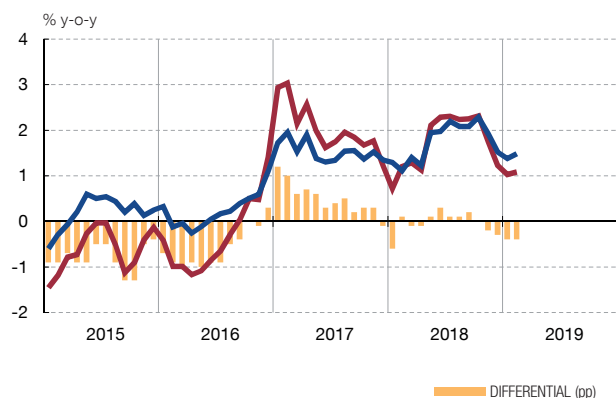
Weaker external inflationary pressures are mainly associated with lower oil prices. In the early months of the year, oil prices are expected to be lower than in 2018. But they will move on an upward path, which would stabilise from Q2, according to the information from futures markets.

2 These measures included most notably, in terms of their scale, on the expenditure side, the revaluation of pensions linked to expected HICP (RDL 27/2018 of 28 December 2018), and public-sector wage rises, according to the agreement reached with the unions in the sector (RDL 24/2018 of 28 December 2018), as well as the increase in paternity leave to eight weeks (RDL 6/2019 of 7 February 2019) and in unemployment benefits for persons over 52 years old (RDL 8/2019 of 8 March 2019). With respect to government revenue, an increase in the minimum contribution base was approved as a result of the national minimum wage increase, and of 7% in the maximum contribution bases (RDL 27/2018 of 28 December 2018).

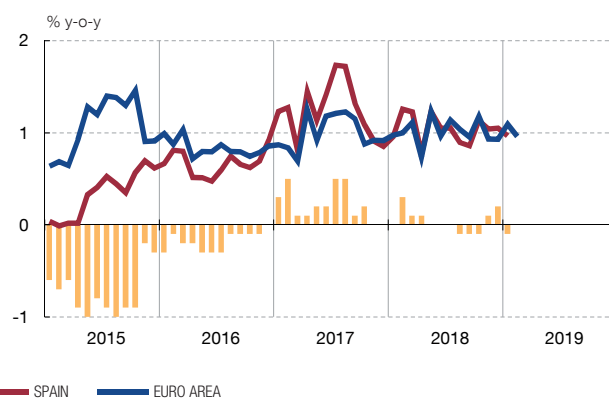
3 For more details, see Box 1 (“Macroeconomic projections for Spain [2019-2021]”) in this report. Also noteworthy is the impact on government revenue of the Supreme Court ruling of October 2018, which stipulates that maternity and paternity benefits are exempt from personal income tax.

Inflation in Spain has grown at a slower pace than in the euro area as a whole, while core inflation has followed a similar pattern, in a context of wage increases and contained external pressures.

1 OVERALL INDEX



2 OVERALL INDEX EXCLUDING ENERGY AND FOOD



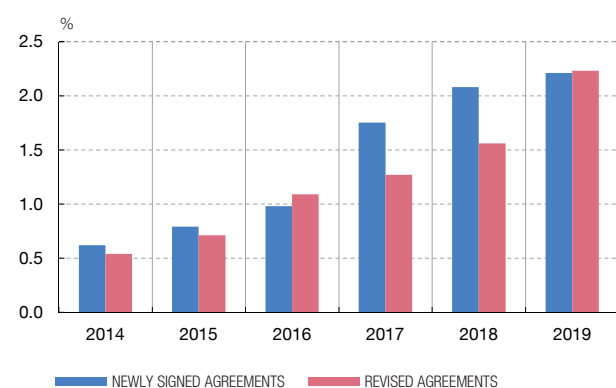
3 NON-ENERGY INDUSTRIAL GOODS (a)



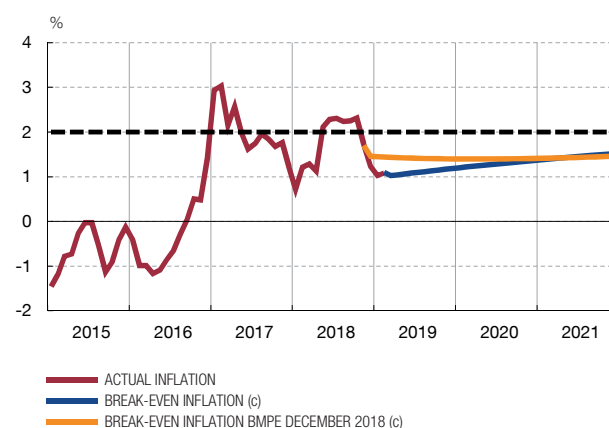
4 OIL PRICES AND FUTURES MARKET



5 AGREED WAGE INCREASES (b)



6 INFLATION EXPECTATIONS



SOURCES: INE, Eurostat, Reuters, Ministerio de Trabajo, Migraciones y Seguridad Social and Banco de España.

a Calculation of indices based on PPI and IPRIM (import price index for industrial products) items reflected in the HICP.

b Based on information to February 2019.

c Break-even inflation calculated on the basis of inflation swaps.



Inflation in the euro area as a whole followed similar patterns by component, but was higher than in Spain. Thus, the growth rate of the HICP stood at 1.5% in February, according to the leading indicator. As a result, Spain's inflation differential vis-à-vis the euro area is expected to remain negative.

Inflation in Spain in recent months has been lower than expected. This has led to the downward revision of the projections for HICP and HICP excluding energy and food for 2019 as a whole, as explained in greater detail in the box on this issue in this report. In addition, agents' medium-term inflation expectations also reflect moderating inflation, possibly as a result of the uncertainty surrounding the macroeconomic performance of the euro area, and of Spain.

As for costs, the wage indicators have accelerated recently, which, a priori, may lead to stronger domestic inflationary pressures in the future. The wage rates set in collective bargaining agreements have risen significantly, based on data to February, and cover a very high number of employees. Specifically, the wage increase agreed for 2019 is 2.2% on average, 0.5 pp higher than in 2018. For now, the vast majority of these agreements were signed in previous years, and little information is available on newly signed agreements. The increases in the newly signed agreements may factor in the above-mentioned rise in the national minimum wage, insofar as they pass it on, at least partially, to the rest of the wage distribution, although this is subject to a high degree of uncertainty. Also, there are doubts as to the extent to which higher wage costs pass through to prices. In many euro area countries, profit margins are acting as a buffer, such that the higher wage increases are not being reflected in prices, at least for the time being.

13.3.2019.

ANALYTICAL ARTICLES

Chronology of Analytical Articles. 2019 Q1.

ADAPTING LENDING POLICIES AGAINST A BACKGROUND OF NEGATIVE INTEREST RATES

Óscar Arce, Miguel García-Posada and Sergio Mayordomo

Published on 12 March 2019

Since June 2014 the European Central Bank (ECB) has placed its deposit facility interest rate (DFR) at negative levels. Against this background, the question arises as to whether maintaining negative interest rates over a prolonged period can adversely affect credit institutions' net interest income and, ultimately, the supply of credit. Euro area banks' responses to the Bank Lending Survey (BLS) enable the banks to be classified into two groups, depending on whether their net interest income has been impaired or not by the negative rates ("affected" versus "unaffected" banks). The analysis in this article shows that the affected banks are generally not as well capitalised. This circumstance might have hindered these banks from taking on fresh risks under their lending policy in order to attempt to offset the adverse effect of the negative rates on their unit lending margins. Indeed, the banks most affected by negative interest rates tightened the terms and conditions on their loans to a greater extent than those unaffected, to optimise their risk-weighted assets and, therefore, their capital ratios. Lastly, the article shows there are no differences between both groups of banks as regards the total credit offered and that the credit supply has been adapted via loan terms and conditions and not through the total amount offered. This result suggests that the current level of the DFR (-0.4%) is not causing a contraction in the volume of credit supplied by the banks affected.

THE EUROSISTEM'S MONETARY POLICY FOLLOWING THE END OF NET ASSET PURCHASES

Óscar Arce, Galo Nuño and Carlos Thomas

Published on 21 February 2019

This article analyses the monetary policy conduct framework in the euro area following the end of net purchases under the financial asset purchase programme. First, there is a review of the monetary policy measures since 2014 and of the ECB's announcements on the future course of its instruments, comparing the recent changes in euro area monetary policy with the normalisation of US monetary conditions initiated by the Federal Reserve in 2013. Second, the authors analyse the main instruments currently available to the ECB (forward guidance on interest rates and its asset portfolio reinvestment policy), and discuss how both instruments provide monetary stimulus in the current setting.

THE LOAN TO VALUE RATIO FOR HOUSING IN SPAIN OVER THE PERIOD 2004-2016

Olympia Bover, María Torrado and Ernesto Villanueva

Published on 12 February 2019

The ratio between the amount of mortgage loans and the value of housing (the loan to value ratio) is a useful indicator for studying the financial situation of households. Two main price indicators are used to measure loan to value ratios for housing in Spain at the time of purchase: the transaction price recorded at the Property Registry and the appraisal value. Having generated a sample in which both price indicators refer to the same set of housing, the median loan to value ratio between 2004 and 2007 is found to stand between 70%, when the appraisal

value is used, and 107%, when the transaction price is used. The difference between these two ratios narrowed from 2010, with the loan to value ratio using the appraisal value remaining at around 70%, while the ratio based on the transaction value fell to 80%. The Spanish Survey of Household Finances (EFF), conducted by the Banco de España, is an alternative data source, allowing a loan to value ratio to be obtained directly from households' responses. This ratio, based on EFF data, has evolved in a similar way to the one derived from the transaction prices recorded at the Property Registry.

THE JANUARY 2019 BANK LENDING SURVEY IN SPAIN

Álvaro Menéndez Pujadas

Published on 22 January 2019

In 2018 Q4, according to the Bank Lending Survey (BLS), credit standards for consumer credit and other lending to households tightened slightly both in Spain and in the euro area. There were no appreciable changes in the other two lending segments. For the current quarter, Spanish banks anticipated a slight tightening in all lending segments, a development also observable in the euro area – albeit to a lesser degree – in practically all segments. The overall terms and conditions on new loans eased across the board, both in Spain and, more moderately, in the euro area as a whole. In Spain, the demand for credit fell both in loans to enterprises and loans to households for house purchase, and it ceased to grow in consumer credit and other lending to households; in the euro area as a whole, meantime, loan applications grew across the board. Conditions of access to wholesale funding markets worsened, both in Spain and in the euro area, whereas in retail markets the changes were minor and of a different sign. According to the banks surveyed, regulatory and supervisory measures in respect of capital, leverage and liquidity did not exert an appreciable impact on the supply of credit in Spain in the second half of 2018, whereas in the euro area they prompted some tightening. Finally, the NPL ratio did not exert any influence on Spanish banks' lending policy in the second half of 2018, while in the euro area they contributed to some tightening in the supply of credit in all segments.

SPANISH BANKS' INTERNATIONALISATION STRATEGY: CHARACTERISTICS AND COMPARISON

Isabel Argimón

Published on 10 January 2019

Banks' international strategy and the way in which they have expanded are explanatory factors for the economic effects of their activity. Based on information from individual institutions, the internationalisation strategies of banks based in Spain, the Netherlands and the United States have been compared. In addition, in the Spanish case, whether banks' risk, efficiency, return and income source type differ according to the chosen model of internationalisation has been tested. The results of this comparison point to Spanish banks with subsidiaries and branches abroad having higher returns but also higher costs than banks whose foreign business is mainly cross-border.

BANCO DE ESPAÑA PUBLICATIONS

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Most of these documents are available in pdf format and can be downloaded free of charge from the Banco de España website at <http://www.bde.es/webbde/en/secciones/informes/>. Requests for others should be addressed to publicaciones@bde.es.

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ACRONYMS AND ABBREVIATIONS

ABS	Asset-backed securities	GDP	Gross domestic product
APP	Asset Purchase Programme	GFCF	Gross fixed capital formation
BCBS	Basel Committee on Banking Supervision	GNP	Gross national product
BE	Banco de España	GOP	Gross operating profit
BIS	Bank for International Settlements	GVA	Gross value added
BLS	Bank Lending Survey	HICP	Harmonised Index of Consumer Prices
BOE	Official State Gazette	IASB	International Accounting Standards Board
CBA	Central Balance Sheet Data Office Annual Survey	ICO	Official Credit Institute
CBQ	Central Balance Sheet Data Office Quarterly Survey	IFRSs	International Financial Reporting Standards
CBSO	Central Balance Sheet Data Office	IGAE	National Audit Office
CCR	Central Credit Register	IIP	International Investment Position
CDSs	Credit default swaps	IMF	International Monetary Fund
CESR	Committee of European Securities Regulators	INE	National Statistics Institute
CNE	Spanish National Accounts	LTROs	Longer-term refinancing operations
CNMV	National Securities Market Commission	MFIs	Monetary financial institutions
CPI	Consumer Price Index	MROs	Main refinancing operations
CSPP	Corporate sector purchase programme	MTBDE	Banco de España quarterly macroeconomic model
DGF	Deposit Guarantee Fund	NAFTA	North American Free Trade Agreement
EBA	European Banking Authority	NAIRU	Non-accelerating-inflation rate of unemployment
ECB	European Central Bank	NCBs	National central banks
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	NFCs	Non-financial corporations
EDP	Excessive Deficit Procedure	NiGEM	National Institute Global Econometric Model
EFF	Spanish Survey of Household Finances	NPISHs	Non-profit institutions serving households
EFSF	European Financial Stability Facility	OECD	Organisation for Economic Co-operation and Development
EMU	Economic and Monetary Union	ONP	Ordinary net profit
EONIA	Euro overnight index average	OPEC	Organisation of Petroleum Exporting Countries
EPA	Official Spanish Labour Force Survey	PER	Price/earnings ratio
ESA 2010	European System of National and Regional Accounts	PMI	Purchasing Managers' Index
ESCB	European System of Central Banks	PPP	Purchasing power parity
ESFS	European System of Financial Supervisors	QNA	Quarterly National Accounts
ESM	European Stability Mechanism	SAFE	ECB Survey on the Access to Finance of Enterprises
ESRB	European Systemic Risk Board	SDRs	Special Drawing Rights
EU	European Union	SEPA	Single Euro Payments Area
EURIBOR	Euro interbank offered rate	SGP	Stability and Growth Pact
EUROSTAT	Statistical Office of the European Communities	SMEs	Small and medium-sized enterprises
FASE	Financial Accounts of the Spanish Economy	SRM	Single Resolution Mechanism
FDI	Foreign direct investment	SSM	Single Supervisory Mechanism
FROB	Fund for the Orderly Restructuring of the Banking Sector	TFP	Total factor productivity
FSB	Financial Stability Board	TLTROs	Targeted longer-term refinancing operations
FSF	Financial Stability Forum	ULCs	Unit labour costs
GDI	Gross disposable income	VAT	Value Added Tax
		WTO	World Trade Organization

COUNTRIES AND CURRENCIES

In accordance with the protocol order, the EU Member States are listed using the alphabetical order of the country names in the national languages.

BE	Belgium	EUR (euro)
BG	Bulgaria	BGN (Bulgarian lev)
CZ	Czech Republic	CZK (Czech koruna)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
EE	Estonia	EUR (euro)
IE	Ireland	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IT	Italy	EUR (euro)
HR	Croatia	HRK (Croatian kuna)
CY	Cyprus	EUR (euro)
LV	Latvia	EUR (euro)
LT	Lithuania	EUR (euro)
LU	Luxembourg	EUR (euro)
HU	Hungary	HUF (Hungarian forint)
MT	Malta	EUR (euro)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PL	Poland	PLN (Polish zloty)
PT	Portugal	EUR (euro)
RO	Romania	RON (New Romanian leu)
SI	Slovenia	EUR (euro)
SK	Slovakia	EUR (euro)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (Pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

CONVENTIONS USED

M1	Notes and coins held by the public + sight deposits.
M2	M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.
M3	M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10 ⁹).
m	Millions.
bp	Basis points.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.